Supreme Court, U.S.
FILED
98 130 JUL 21 1998
OFFICE OF THE CLERK

No.

In the Supreme Court of the United States

OCTOBER TERM, 1997

UNITED STATES OF AMERICA,
PETITIONER

v.

CONTINENTAL AIRLINES
THOMAS E. ROSS, TRUSTEE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

SETH P. WAXMAN
Solicitor General
Counsel of Record
FRANK W. HUNGER
Assistant Attorney General
LAWRENCE G. WALLACE
Deputy Solicitor General
DAVID C. FREDERICK
Assistant to the Solicitor General
WILLIAM KANTER
ROBERT M. LOEB
Attorneys
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

93 pp

QUESTIONS PRESENTED

Whether, notwithstanding 11 U.S.C. 553(a)'s provision that "this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title," the confirmation of a bankruptcy reorganization plan under 11 U.S.C. 1141 causes a creditor to lose its setoff rights against the debtor.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	2
Statutory provisions involved	2
Statement	2
Reasons for granting the petition	7
Conclusion	19
Appendix A	1a
Appendix B	15a
Appendix C	18a
Appendix D	31a
Appendix E	52a
Appendix F	59a
Appendix G	61a
Appendix H	63a
Appendix I	65a

TABLE OF AUTHORITIES

Cases:

Alaska Airlines, Inc. v. *Austin*, 801 F. Supp. 760 (D.D.C. 1992), aff'd in part, rev'd in part, 8 F.3d 791 (Fed. Cir. 1993) 4, 5

Alaska Airlines v. *Jones*, Nos. 93-1028, 93-1117, 93-1125, & 93-1161 (Fed. Cir. Feb. 25, 1993) 4, 5

Bevill, Bresler & Schulman Asset Management Corp., In re, 896 F.2d 54 (3d Cir. 1990) 8

Buckenmaier, In re, 127 B.R. 233 (B.A.P. 9th Cir. 1991) 12

Buckner, In re, 218 B.R. 137 (B.A.P. 10th Cir. 1998) 12

Citizens Bank of Maryland v. *Strumpf*, 516 U.S. 16 (1995) 5, 6, 7, 8, 10, 11, 12, 15

Davidovich, In re, 901 F.2d 1533 (10th Cir. 1990) 12, 14, 15, 17

Cases—Continued: Page

Davis, In re, 889 F.2d 658 (5th Cir. 1989), cert. denied, 495 U.S. 933 (1990) 8
De Laurentiis Entertainment Group, Inc., In re, 963 F.2d 1269 (9th Cir.), cert. denied 506 U.S. 918 (1992) 9, 12, 13, 15, 16, 17
Dezarn, In re, 96 B.R. 93 (Bankr. E.D. Ky. 1988) 13
Hackney, In re, 20 B.R. 158 (Bankr. D. Idaho 1982) .. 13
Hall v. *National Gypsum Co.*, 105 F.3d 225 (5th Cir. 1997) 16
Holcomb, In re, 18 B.R. 839 (Bankr. S.D. Ohio 1982) 13
Holder, In re, 182 B.R. 770 (Bankr. M.D. Tenn. 1995) 12
Johnson, In re, 13 B.R. 185 (Bankr. M.D. Tenn. 1981) 13
Johnson v. *Home State Bank*, 501 U.S. 78 (1991) ... 16
Newbery Corp. v. *Fireman's Fund Ins. Co.*, 95 F.2d 1392 (9th Cir. 1996) 15
Patterson, In re, 967 F.2d 505 (11th Cir. 1992) 8
Pettibone Corp., In re, 161 B.R. 960 (N.D. Ill. 1993), aff'd in part, and remanded in part on other grounds, 34 F.3d 536 (7th Cir. 1994) 12, 16
Sedlock, In re, 219 B.R. 207 (Bankr. N.D. Ohio 1998) 12
South Park Care Assocs., In re, 203 B.R. 445 (Bankr. W.D. Mo. 1996) 12
Studley v. *Roylston Nat'l Bank*, 229 U.S. 523 (1913) 8
United States v. *Norton*, 717 F.2d 767 (3d Cir. 1983) 5, 6, 11, 12, 13, 14
Walker, In re, 927 F.2d 1138 (10th Cir. 1991) 16
Wiegand, In re, 199 B.R. 639 (W.D. Mich. 1996) 12, 17
Womack, In re, 188 B.R. 259 (Bankr. E.D. Ark. 1995) 12

Statutes: Page

Bankruptcy Code 11 U.S.C. 101 *et seq.*:
11 U.S.C. 362 ..... 9, 10
11 U.S.C. 363 ..... 9, 10
11 U.S.C. 524 ..... 10, 14
11 U.S.C. 542(b) 5
11 U.S.C. 553 ..... 5, 6, 7, 9, 10, 11, 13, 15, 16, 17, 65a
11 U.S.C. 553(a) 9, 10, 13, 14, 65a
11 U.S.C. 1141 ..... 5, 6, 7, 10, 11, 13, 14, 67a
11 U.S.C. 1141(b) 10, 67a
11 U.S.C. 1327 10

Miscellaneous:

5 *Collier on Bankruptcy* (15th rev. ed. 1997) 8, 13, 15, 17
W. Lloyd, *The Development of Setoff*, 64 U. Pa. L. Rev. 541 (1916) 8

In the Supreme Court of the United States

OCTOBER TERM, 1997

No.

UNITED STATES OF AMERICA,
PETITIONER

v.

CONTINENTAL AIRLINES
THOMAS E. ROSS, TRUSTEE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-14a) is reported at 134 F.3d 536. The opinion of the district court (App., *infra*, 18a-30a) is reported at 218 B.R. 324. The report and recommendations of the magistrate judge (App., *infra*, 31a-51a) and the decision of the bankruptcy court are unreported (App., *infra*, 52a-56a).

JURISDICTION

The judgment of the court of appeals was entered on January 20, 1998, and was amended on March 23, 1998. A petition for rehearing was denied on March 23, 1998. On June 12, 1998, Justice Souter extended the time for filing a petition for a writ of certiorari to and including July 21, 1998. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

Sections 553 and 1141 of the Bankruptcy Code, 11 U.S.C. 553, 1141, are reproduced at App., *infra*, 65a-68a.

STATEMENT

1. In December 1990, Continental Airlines filed a petition for reorganization under Chapter 11 of the Bankruptcy Code. Several federal agencies filed claims that totaled more than $14 million.[1] The debtor challenged many of those government claims as to their amounts and validity. To date, most of those challenges have not yet been resolved.

The claims filed by the various federal agencies followed different forms. The proof of claim filed on November 27, 1991, by the Federal Aviation Admini-

---

[1] The claims were filed by the Immigration and Naturalization Service ($5,859,955.06), the United States Customs Service ($5,420,830), the Federal Aviation Administration ($3,405,700), the United States Postal Service ($42,275), the Department of Agriculture ($94,266.71), the United States Air Force ($155,572.89), the Department of Labor ($42,000), the Equal Employment Opportunity Commission ($3,500), the Drug Enforcement Administration ($837.50), and the Peace Corps ($934.90). See C.A. App. 58 (Attachment (Facts) to Bankruptcy Court Order dated Sept. 30, 1993); C.A. App. 50 (Proofs of Claim Filed on Behalf of the United States).

stration (FAA) stated: "The United States reserves its right to effect any and all appropriate setoffs." C.A. App. 40 (FAA Proof of Claim, Rider A). Neither the trustee nor any other party objected to or opposed the claim filed by the FAA, or challenged the expressed reservation of the setoff rights of the United States. Other claims did not expressly preserve the government's setoff rights. See App., *infra*, 32a-35a.

On April 16, 1993, the bankruptcy court confirmed respondent's reorganization plan. Under the plan, as unsecured creditors, the federal agencies were to receive payment equivalent to approximately 4.8 percent of their allowed claims. The Plan of Reorganization further provided that the Debtor and the new entity, "New Cal," could, but were not required to, exercise their own setoff rights available under applicable law. See C.A. Supp. App. B-50 (Debtor's Second Revised Amended Joint Plan of Reorganization ¶ 14.8). The plan did not provide for or mention the setoff rights of creditors.

2. In September 1990, before it filed for bankruptcy, Continental Airlines, together with several other airlines, filed an action in the U.S. District Court for the District of Columbia seeking to force the General Services Administration (GSA) to pay for air travel. GSA had withheld funds because of perceived overcharges by the airlines on past air travel. On August 11, 1992, the district court granted summary judgment in favor of the airlines.[2] The district court ordered GSA to return "all monies held

---

[2] The court held that, although GSA has the right to audit ticket payments and to withhold funds based upon past overcharges, it could not conduct audits on the premise that the government was entitled to the lowest fare available.

improperly." *Alaska Airlines, Inc.* v. *Austin*, 801 F. Supp. 760 (D.D.C. 1992), aff'd in part, rev'd in part, 8 F.3d 791 (Fed. Cir. 1993).

When the district court refused to stay its order requiring GSA to pay the airlines, the United States sought a stay from the Federal Circuit. The court of appeals initially denied a stay. The United States filed a motion for partial reconsideration, pointing out that if it turned over the funds to the airlines in bankruptcy, it could lose the right to set off the funds against debts owed by the airlines to the United States. The United States asked for permission to pay the funds into the registries of the respective bankruptcy courts so that the funds could be held in escrow while the government asserted its setoff rights in bankruptcy court. In response to the United States' motion expressly seeking to preserve its setoff rights, the Federal Circuit issued an order on February 25, 1993, staying the district court's order to pay the airlines in bankruptcy. *Alaska Airlines* v. *Jones*, Nos. 93-1028, 93-1117, 93-1125 & 93-1161 (Fed. Cir. Feb. 25, 1993) (Order per Rich, J.). Then, on April 12, 1993, to afford the United States an opportunity to assert its setoff rights before turning the funds over to the airlines in bankruptcy, the Federal Circuit modified the district court's order and directed the United States to deposit the funds in the registries of the bankruptcy courts for the airlines then in bankruptcy proceedings. C.A. App. 26-27 (Federal Circuit Order dated April 12, 1993). Accordingly, on May 19, 1993, more than one month after the confirmation of the respondent's reorganization plan, the United States deposited $4,763,219.60 with the registry of the Bankruptcy Court for the District of Delaware. App., *infra*, 16a, 58a.

3. On May 28, 1993, the United States filed a motion in the bankruptcy court seeking permission, pursuant to 11 U.S.C. 553, to set off the deposited funds against Continental's prepetition debts to the United States. On September 30, 1993, the bankruptcy court denied the motion. The bankruptcy court held, *inter alia*, that the United States lost its setoff rights when the reorganization plan was confirmed. Relying upon *United States* v. *Norton*, 717 F.2d 767 (3d Cir. 1983), the bankruptcy court held that, under 11 U.S.C. 1141, upon confirmation of the plan all property of the estate vested in the newly-reorganized entity free and clear of any claims or interests. App., *infra*, 54a.

4. The government appealed the bankruptcy court's ruling to the district court. The district court referred the matter to a magistrate judge, who filed a report and recommendations agreeing with the bankruptcy court. App., *infra*, 31a-51a. On January 9, 1997, the district court issued an order affirming the decision of the bankruptcy court. App., *infra*, 18a-30a. Relying on *Norton*, *supra*, the district court held that, under 11 U.S.C. 1141, confirmation of a Chapter 11 plan extinguishes a creditor's right to setoff. App., *infra*, 29a.

5. The United States appealed to the United States Court of Appeals for the Third Circuit, and argued that the reasoning of *Norton* was inconsistent with the rationale of *Citizens Bank of Maryland* v. *Strumpf*, 516 U.S. 16 (1995). The government contended that, under *Strumpf*, funds held by a creditor that may be subject to a setoff right are not to be treated as "property of the estate." Hence, such funds do not vest free and clear in the reorganized debtor upon confirmation of a plan of reorganization.

The United States also contended that confirmation under Section 1141 cannot extinguish pre-petition setoff rights because Section 553 specifies that none of the Code provisions (except as provided therein) affect a creditor's setoff rights.

On January 20, 1998, the Third Circuit affirmed the district court's judgment. The court agreed that *Norton* "implicitly held that the funds withheld by the creditor subject to set-off were 'property of the estate,'" and that under *Strumpf*, "the relevant 'property of the estate' is instead the bankrupt debtor's claim to the funds as opposed to the possession of the physical funds themselves." App., *infra*, 7a-8a. The court distinguished *Norton* and *Strumpf* on the ground that, in both of those cases, "the creditor retained possession of the funds; here the Government deposited the $4.8 million into the registry of the court pending an appeal." App., *infra*, 8a. The court held that such funds "are comparable to the res of a trust," and that the government had no beneficial interest in the funds at that juncture. *Ibid.* The court explained that, under *Norton*, the government's setoff right was extinguished by the confirmation of the plan: "Although the actual funds themselves may not have passed as property of the estate, upon confirmation of the plan, [respondent] did acquire a claim or interest in them subject only to final resolution of the Government's appeal." *Ibid.*

The court reasoned that allowing the government to attempt to exercise its setoff right post-confirmation could disadvantage the other unsecured creditors, disrupt the plan of reorganization, and protract the bankruptcy proceedings. App., *infra*, 9a-10a. Thus, the court concluded, "we reaffirm the ruling in *Norton* and hold that the right of a creditor to set-off

in a bankruptcy reorganization proceeding must be duly exercised in the bankruptcy court before the plan of reorganization is confirmed; the failure to do so extinguishes the claim." *Id.* at 13a.

6. On March 5, 1998, the United States filed a timely petition for rehearing and suggestion for rehearing *en banc*. In the petition, the government argued that the court's ruling was legally erroneous, inconsistent with this Court's *Strumpf* decision, in conflict with decisions of the Ninth and Tenth Circuits, contrary to the prevailing view of the lower courts, and based upon several critical erroneous factual assumptions. One of the factual errors identified in the rehearing petition was that the court of appeals appeared to base its legal conclusion on the incorrect assumption that the $4.8 million was in the estate's possession prior to confirmation of the plan of reorganization. On March 23, 1998, the court of appeals amended its decision to reflect that those funds were in fact held by the government until after the confirmation of the plan. Compare App., *infra*, 16a with App., *infra*, 8a. On that same date, the court denied the petition and the suggestion for rehearing *en banc*. *Id.* at 61a-62a.

REASONS FOR GRANTING THE PETITION

The court of appeals held that a creditor's setoff rights must be asserted in the bankruptcy proceedings and that setoff rights not asserted or provided for in the reorganization plan are extinguished by a Section 1141 confirmation order. That decision is inconsistent with the plain language of Section 553, this Court's decision in *Citizens Bank of Maryland* v. *Strumpf*, 516 U.S. 16 (1995), and the majority of court decisions, including decisions of the Ninth and Tenth

Circuits. Because the issue is fundamental to the sound administration of the Nation's bankruptcy laws—for governmental and private creditors alike—the Court should grant review.

1. a. The right of setoff permits a creditor to deduct a debt it owes to a debtor from a claim the creditor has against the debtor arising out of a separate transaction. See 5 *Collier on Bankruptcy* ¶ 553.01 (15th rev. ed. 1998). It "allows parties that owe mutual debts to state the accounts between them, subtract one from the other and pay only the balance." *In re Bevill, Bresler & Schulman Asset Management Corp.*, 896 F.2d 54, 57 (3d Cir. 1990). Setoffs have been an established part of the law dating back to the Roman Empire and have been incorporated into American bankruptcy law consistently since 1800. See *In re Davis*, 889 F.2d 658, 661 n.5 (5th Cir. 1989), cert. denied, 495 U.S. 933 (1990); 5 *Collier on Bankruptcy*, *supra*, ¶ 553.LH. The rule is based upon the "common sense notion that 'a man should not be compelled to pay one moment what he will be entitled to recover back the next.'" *In re Davis*, 889 F.2d at 661 n.5 (quoting Lloyd, *The Development of Setoff*, 64 U. Pa. L. Rev. 541, 541 (1916)). See also *In re Patterson*, 967 F.2d 505, 508 (11th Cir. 1992). This Court recently explained:

> The right of setoff (also called "offset") allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding "the absurdity of making A pay B when B owes A."

Citizens Bank of Maryland v. *Strumpf*, 516 U.S. at 18 (quoting *Studley* v. *Boylston Nat'l Bank*, 229 U.S. 523, 528 (1913)).

In the bankruptcy context, without the right of setoff a creditor would have the "worst of both worlds." *In re De Laurentiis Entertainment Group, Inc.*, 963 F.2d 1269, 1277 (9th Cir.), cert. denied, 506 U.S. 918 (1992). Absent the setoff right, the creditor would have to pay the debtor in full, but would recover only a small portion of the fund it is owed. *Ibid.* To avoid that fundamental unfairness, Congress enacted Section 553 of the Bankruptcy Code. That provision specifically recognizes and preserves a creditor's setoff rights by stating that a creditor's setoff right for pre-petition mutual debts is *not* subject to the other Code provisions, except Sections 362 and 363 of the Code:

> Except as otherwise provided in this section and in sections 362 and 363 of this title, *this title does not affect any right* of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case * * *.

11 U.S.C. 553(a) (emphasis added).

Section 553's instruction that "this title does not affect any right" of setoff on its face means that the other provisions of Title 11 (not mentioned in Section 553) simply do not affect a creditor's right to setoff. See *In re De Laurentiis Entertainment Group, Inc.*, 963 F.2d at 1276-1277. The court of appeals here held that the confirmation of a bankruptcy plan causes a creditor's claim to be discharged (except insofar as payment is provided for in the plan), and that the creditor's pre-petition setoff rights not provided for in the plan are extinguished upon confirmation. The

Code's provisions regarding discharge of debts and confirmation of reorganization plans, 11 U.S.C. 524, 1141, 1327, however, are *not* among the provisions listed in Section 553. See App., *infra*, 65a-66a. Because Section 1141 is omitted from the expressly specified provisions that create exceptions, the court of appeals' ruling conflicts with Section 553's general rule that a creditor's rights are not affected by the Bankruptcy Code.

b. Indeed, this Court has recognized that "Section 553(a) * * * sets forth a general rule, with certain exceptions, that any right of setoff that a creditor possessed prior to the debtor's filing for bankruptcy is not affected by the Bankruptcy Code." *Strumpf*, 516 U.S. at 20. Those "certain exceptions," the Court made clear, are those explicitly stated in the text of Section 553 "and in sections 362 and 363." *Ibid.* (quoting 11 U.S.C. 553(a)). The court below instead based its holding on Section 1141 of the Bankruptcy Code, which concerns the "property of the estate." See 11 U.S.C. 1141(b) ("Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor."). The court of appeals reasoned that, because confirmation vested a property right in the debtor's estate, the creditor's setoff rights were thereby extinguished because the debtor had a claim to that property. App., *infra*, 7a-8a; 16a-17a.

The court of appeals' holding and rationale cannot be squared with *Strumpf*, *supra*. In *Strumpf*, a bank held funds subject to a setoff right. The estate argued that the bank's retention of the funds violated the Bankruptcy Code's automatic stay, which prohibits a creditor from exercising "dominion over property that belong[s] to the [estate]." 516 U.S. at 21. This

Court unanimously rejected that argument, holding that refusal to pay a debt subject to a right of setoff is not an exercise of control over property of the estate. The Court explained that the refusal to pay "was neither a taking of possession of [the debtor's] property nor an exercising of control over it, but merely a refusal to perform [the creditor's] promise." *Ibid.*[3] Hence, under *Strumpf*, funds held by a creditor subject to a setoff claim are not "property of the estate." Those funds, therefore, are not properly subject to a Section 1141 confirmation order that would take precedence over a Section 553 right of setoff.

The decision below relied on circuit precedent that pre-dated *Strumpf*. See App., *infra*, 7a-9a, 16a-17a (discussing *United States* v. *Norton*, 717 F.2d 767 (3d Cir. 1983)). *Norton* treated funds held by the creditor subject to a possible setoff right as "property of the estate." Accordingly, *Norton* concluded that such funds vested free and clear in the reorganized entity emerging from bankruptcy. After *Strumpf*, however, it is now clear that *Norton*'s fundamental premise was incorrect. Funds being held by the creditor at the time of confirmation are not "property of the estate." See 516 U.S. at 21. Thus, such funds do not vest free and clear in the reorganized debtor upon confirmation of the plan.

The court of appeals here conceded that *Norton*'s reasoning is incorrect in one respect in light of this Court's subsequent decision in *Strumpf*. App., *infra*,

---

[3] The Court declined to address the issue raised in this petition, whether "confirmation of [the debtor's] Chapter 13 plan under 11 U.S.C. § 1327 precluded petitioner's exercise of its setoff right," because the respondent had not raised that contention in the courts below. See 516 U.S. at 21 n.*.

6a. On the government's petition for rehearing, the court further conceded that the basic factual predicate for its initial decision—that the funds had been transferred from the government to the court registry (and thereby, in the court's view, were part of the debtor's estate) prior to confirmation of the plan—was also incorrect. See App., *infra*, 16a. The court nonetheless adhered to the result in *Norton* that a creditor loses its setoff right upon confirmation. The court provided no cogent explanation for that conclusion, or how it can be reconciled with the language of Section 553 and this Court's decision in *Strumpf*. App., *infra*, 16a-17a.

2. The court of appeals' decision conflicts with those of the majority of other courts, which have held that neither confirmation of a reorganization plan nor discharge of a claim affects a creditor's setoff rights for mutual pre-petition debts. See *In re De Laurentiis Entertainment Group, Inc.*, 963 F.2d at 1276-1277; *In re Davidovich*, 901 F.2d 1533, 1539 (10th Cir. 1990); *In re South Park Care Assocs.*, 203 B.R. 445, 447-448 (Bankr. W.D. Mo. 1996); *In re Wiegand*, 199 B.R. 639, 641-642 (W.D. Mich. 1996); *In re Pettibone Corp.*, 161 B.R. 960 (N.D. Ill. 1993), aff'd in part, and remanded in part on other grounds, 34 F.3d 536 (7th Cir. 1994); *In re Buckner*, 218 B.R. 137, 144 (B.A.P. 10th Cir. 1998); *id.* at 149 (Matheson, Bankruptcy Judge, concurring); *In re Buckenmaier*, 127 B.R. 233, 236-237 (9th Cir. B.A.P. 1991); *In re Sedlock*, 219 B.R. 207, 209-210 (Bankr. N.D. Ohio 1998); *In re Holder*, 182 B.R. 770, 775 (Bankr. M.D. Tenn. 1995); *In re Womack*, 188 B.R. 259, 261-262 (Bankr. E.D. Ark. 1995). That conflict has been noted by the leading commentary on bankruptcy law, which has endorsed the majority position as the "better view" that confirmation and discharge

by a reorganization plan do not extinguish a creditor's setoff rights. 5 *Collier on Bankruptcy*, *supra*, ¶ 553.08[1]-[2].[4]

The court of appeals attempted to distinguish *In re De Laurentiis Entertainment Group* on the ground that the Ninth Circuit "predicated its decision upon the particular facts * * *, including the creditor's diligent pursuit of its set-off claim before the bankruptcy court." App., *infra*, 10a. The Ninth Circuit mentioned those facts, however, only *after* it had already ruled, as a matter of law and of statutory construction, that confirmation of a bankruptcy reorganization plan does not compromise a creditor's setoff rights. *In re De Laurentiis Entertainment Group*, 963 F.2d at 1276-1277. The Ninth Circuit explained that Section 553(a)'s "language not only establishes a right to setoffs in bankruptcy, subject to enumerated exceptions, but seems intended to control notwithstanding any other provision of the Bankruptcy Code." *Ibid.* "To give section 1141 precedence would be to ignore this language." *Id.* at 1277. Thus, the court held:

> We conclude that section 553 must take precedence over section 1141. In reaching this conclusion, we rely not only on the foregoing persuasive authority, but also on the language and structure of section 553 and the policies which underlie it.

---

[4] For the "minority" view cases, see, *e.g.*, *United States* v. *Norton*, 717 F.2d 767, 774 (3d Cir. 1983); *In re Dezarn*, 96 B.R. 93, 94-95 (Bankr. E.D. Ky. 1988); *In re Hackney*, 20 B.R. 158, 159 (Bankr. D. Idaho 1982); *In re Holcomb*, 18 B.R. 839, 841 (Bankr. S.D. Ohio 1982); *In re Johnson*, 13 B.R. 185, 188-189 (Bankr. M.D. Tenn. 1981).

Id. at 1276. That holding is directly contrary to the court of appeals' decision in this case.

The Third Circuit's decision is also at odds with the Tenth Circuit's decision in *In re Davidovich*, 901 F.2d at 1538-1539. In *Davidovich*, the creditor asserting the setoff right did not file a proof of claim or assert its setoff right in the bankruptcy proceeding prior to the court's discharge order. Although *Davidovich* involved a Chapter 7 bankruptcy, the court's analysis is not limited to that context.[5] Whether the discharge order is under Section 524 (as in *Davidovich*) or under Section 1141 (as is the case here and in *De Laurentiis*), the relevant legal question is whether, notwithstanding the discharge of the debtor's personal obligations, the plain language of Section 553(a) controls and the creditor's setoff rights as to mutual pre-petition claims remain intact. On that question the Tenth Circuit held that, under Section 553(a), the Bankruptcy Code "does not affect" a creditor's setoff rights. *In re Davidovich*, 901 F.2d at 1539. The court concluded that a creditor need not file a claim to preserve a setoff right, and that "the right to assert a setoff against a mutual prepetition debt * * * survives even the Bankruptcy Court's discharge of the bankrupt's debts." *Ibid.*

3. By ignoring the clear language of Section 553(a) and adopting the minority view of the extinguishment of creditor's rights after confirmation of the debtor's plan, the court of appeals has significantly impaired creditors' rights in bankruptcy in several important respects.

---

[5] Similarly, the court below concluded that Third Circuit precedent in *Norton* was not limited to the Chapter 13 context. See 717 F.2d at 774.

a. Under the Code, a creditor owing funds to the debtor is expressly permitted to retain the funds that are possibly subject to a setoff right. See 11 U.S.C. 542(b). The creditor may hold the funds without violating the automatic bankruptcy stay and wait for the debtor or estate to sue it to recover the funds. See *Strumpf*, 516 U.S. at 20-21. When the debtor or estate sues the creditor, the creditor may then raise the setoff as a defense. See *Newbery Corp.* v. *Fireman's Fund Ins. Co.*, 95 F.3d 1392, 1398 (9th Cir. 1996); *In re De Laurentiis Entertainment Group, Inc.*, 963 F.2d at 1277; *In re Davidovich*, 901 F.2d at 1539; 5 *Collier on Bankruptcy, supra*, ¶ 553.07[1]-[2].

By contrast, the court of appeals here held that the setoff right abates unless it is adjudicated before confirmation or preserved explicitly in the confirmed plan of reorganization. That ruling has the effect of preventing a creditor from retaining funds subject to a setoff claim and raising the setoff right as a defense when sued by the debtor, as the creditor is otherwise permitted to do under the Code. The holding below instead requires a creditor affirmatively to assert its setoff right in the bankruptcy proceeding, and mandates that the setoff defense will be lost if not provided for in the reorganization plan. App., *infra*, 13a. The Ninth Circuit specifically rejected that view, under which "setoffs would be allowed under Chapter 11 only where they were written into a plan of reorganization." *In re De Laurentiis Entertainment Group, Inc.*, 963 F.2d at 1277. By giving no effect to Section 553 unless a creditor affirmatively seeks to have its setoff rights expressly protected in the plan, the Third Circuit's rule would leave a creditor's setoff rights subject to the will of the other creditors

(who, like the debtor, would ordinarily have no incentive to grant the setoff rights).

As the Ninth Circuit has held, that result is tantamount to reading Section 55? out of the Bankruptcy Code. *In re De Laurentiis Entertainment Group, Inc.*, 963 F.2d at 1277 ("Section 553 would then be largely superfluous, since a setoff could be written into the plan even without section 553."). See also *In re Pettibone Corp.*, 161 B.R. at 964. No Code provision, however, requires the assertion of the setoff in a proof of claim or any other type of assertion of a setoff right in the bankruptcy court prior to confirmation.

b. The court of appeals' decision also rests upon a fundamental misunderstanding of the effect of a discharge under established principles of bankruptcy law. A discharge does *not* eliminate or extinguish a debt. It prohibits the creditor from enforcing it as a "personal liability" against the reorganized entity emerging from bankruptcy after discharge. See *Hall* v. *National Gypsum Co.*, 105 F.3d 225, 229 (5th Cir. 1997). Discharge of a debt does not prevent a creditor from enforcing the debt in other ways, such as against a co-signor, guarantor, or surety. See *In re Walker*, 927 F.2d 1138 (10th Cir. 1991). See also *Johnson* v. *Home State Bank*, 501 U.S. 78, 84 (1991) ("a bankruptcy discharge extinguishes only one mode of enforcing a claim—namely, an action against the debtor *in personam*"). As to enforcement of a debt post-discharge, the "crucial inquiry" is whether the creditor is seeking to collect property of the estate that vested free and clear in the new entity. If so, the discharge order bars the collection. See *Hall*, 105 F.3d at 229. If not, the collection effort is entirely proper under the Code.

The assertion of a pre-petition setoff right against a pre-petition claim is not an attempt to collect affirmatively from the new entity. See *In re DeLaurentiis*, 963 F.2d at 1278; *In re Wiegand*, 199 B.R. at 641-642. Nor (as the court of appeals here conceded) is it an attempt to collect property that was in the estate at the time of the discharge order. Thus, as the Tenth Circuit has held, "the right to assert a setoff against a mutual, prepetition debt owed the bankrupt estate survives even the Bankruptcy Court's discharge of the bankrupt's debts." *In re Davidovich*, 901 F.2d at 1539; see also 5 *Collier on Bankruptcy*, *supra*, ¶ 553.08[1]-[2]. The decision below is directly to the contrary.

c. The court further erred in assuming that the assertion of a setoff right post-confirmation would disadvantage the other creditors and could disrupt the reorganization plan. See App., *infra*, 12a. Not only are those policy considerations insufficient to overcome the plain language of Section 553, they are incorrect in their own right. The reorganization plan approved in this case did not mention the *Alaska Airline* litigation or include proceeds from it as an asset. The plan did not distribute the *Alaska Airline* funds to the creditors or rely on the funds to support the reorganized debtor. C.A. Supp. App. B135-B138. Indeed, respondent apparently plans to keep those disputed funds for itself. Thus, permitting the government to assert a setoff right would not disadvantage any other creditor.

Nor was the court of appeals persuasive in suggesting that post-confirmation setoffs would protract bankruptcy proceedings. Chapter 11 bankruptcy proceedings do not end upon confirmation of the reorganization plan. The federal agencies have not yet

been paid anything on the bulk of their claims (which were duly filed in a timely fashion in the bankruptcy proceeding) almost *five years after confirmation* of respondent's plan, because the trustee's objections to the claims have not yet been adjudicated. Plainly, the bankruptcy proceedings here have not ended with the confirmation of the plan; allowing the United States to retain its setoff rights would not unduly delay the administration of the reorganization plan. Nor is this case factually unique in that respect. In any event, a creditor's post-confirmation assertion of setoff rights generally should not unduly delay the bankruptcy proceedings. A debtor can always force the creditor's hand by suing the creditor for the funds and thereby require the creditor to assert the setoff defensively before the funds are turned over.

Indeed, not only was the court incorrect in assuming that other creditors and the bankruptcy process itself would suffer, its decision places an unjustified and disproportionate burden on creditors that have setoff rights—whether they are private or public entities. Debtors will have every incentive to omit any reference to setoff rights in the plan and to do nothing about setoff until the plan is confirmed. Other creditors will not know of the funds the debtor plans to obtain after confirmation, and the plan will not provide for their distribution to creditors. Only the reorganized debtor stands to benefit from the extinguishment of a creditor's setoff rights. The decision below would allow debtors to obtain assets to which they had no right at the time of the bankruptcy filing and would ensure that those assets will not be distributed pursuant to the plan. As a result, creditors would have to monitor all plans of reorganization and object to every plan that does not contain an

express preservation of their setoff rights. Such a requirement would needlessly protract bankruptcy proceedings and require the expenditure of scarce resources. This Court should not countenance such an unwarranted departure from the express statutory scheme Congress has provided.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted.

SETH P. WAXMAN
Solicitor General
FRANK W. HUNGER
Assistant Attorney General
LAWRENCE G. WALLACE
Deputy Solicitor General
DAVID C. FREDERICK
Assistant to the Solicitor General
WILLIAM KANTER
ROBERT M. LOEB
Attorneys

JULY 1998

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 97-7109
Civil Action No. 93-cv-00485

IN RE: CONTINENTAL AIRLINES, DEBTOR

UNITED STATES OF AMERICA, APPELLANT

v.

CONTINENTAL AIRLINES

THOMAS E. ROSS, TRUSTEE

An Appeal from the United States District Court
for the District of Delaware

Argued December 2, 1997
[Filed: January 20, 1998]

Before: COWEN, MCKEE and ROSENN, Circuit Judges.

OPINION OF THE COURT

ROSENN, Circuit Judge.

This appeal presents an issue pertaining to the right of set-off by a pre-bankruptcy creditor after a plan of reorganization has been approved by the bank-

ruptcy court. Continental Airlines and its affiliates (Continental or Debtors) filed petitions for reorganization under Chapter 11 of the Bankruptcy Code. In April, 1990, the bankruptcy court confirmed the Debtors' Joint Plan of Reorganization. In addition to ten federal government agencies that had timely filed proofs of claim, the General Services Administration of the United States (GSA or Government) filed an amended proof of claim on May 25, 1993, after the confirmation of the plan, and specifically asserted a right of set-off for the first time. The bankruptcy court held that the Government could not exercise set-off rights with respect to $4.8 million due the Debtor and ordered it to pay the sum to the Debtors. The Government appealed to the United States District Court for the District of Delaware which affirmed. The Government then timely appealed to this court.[1] We also affirm.

I.

On December 3, 1990, Continental filed for Chapter 11 reorganization in the United States Bankruptcy Court for the District of Delaware. Subsequently, each of ten agencies of the United States Government filed separate proofs of claim with the bankruptcy court for monies owed to them by Continental, which in aggregate totaled approximately $14.5 million. Continental submitted its revised final reorganization plan to the bankruptcy court on January 13, 1993. Although the court resolved several objections by the

---

[1] The bankruptcy court had jurisdiction over this matter pursuant to 28 U.S.C. § 157(b). The district court had jurisdiction to review the bankruptcy court's decision pursuant to 28 U.S.C. § 158(a). This Court has appellate jurisdiction of the district court's order pursuant to 28 U.S.C. § 1291.

various agencies to Continental's proposed plan, no government agency sought to amend its proofs of claim to assert any additional claims, including a right to set-off the $4.8 million owed by GSA. Accordingly, the bankruptcy court entered its order confirming the plan on April 16, 1993 without any objection from the Government.

Under the confirmed plan, the federal agencies were treated as general unsecured creditors, and were entitled to recover approximately 4.8% of their total claims. The Government did not appeal the confirmation order. Meanwhile, in August 1992, in a suit unrelated to Continental's bankruptcy petition, the United States District Court for the District of Columbia ordered GSA to return money it had wrongfully withheld from several airlines, including approximately $4.8 million withheld from Continental.[2] The Government sought a stay of the district court's order in the United States Court of Appeals for the Federal Circuit. On April 12, 1993, the Federal Circuit issued an order denying the Government's request for a stay, but instead permitted it to deposit the disputed sum into the registry of the bankruptcy court while the Government attempted to set-off the $4.8 million it owed against the $14.5 million in claims due its agencies.

Subsequently, on May 28, 1993, the GSA filed a motion with the bankruptcy court seeking to set-off its claim against the funds deposited in the bankruptcy court's registry. On September 30, 1993, the

---

[2] *Alaska Airlines, Inc. v. Austin*, 801 F.Supp. 760 (D.D.C. 1992). The facts of *Alaska Airlines, Inc. v. Austin* are not relevant to the issues raised on this appeal.

bankruptcy court denied the Government's motion, ruling that the Government could not exercise its set-off rights with respect to the $4.8 million and ordered it to pay the money to the Debtor. After the Government appealed, the District Court for the District of Delaware affirmed the bankruptcy court's ruling.

II.

This Court's review of a district court's disposition of a bankruptcy appeal is plenary. The Court of Appeals exercises "the same review of the district court's decision as that exercised by the district court. The bankruptcy court's findings of fact are reviewable only for clear error. Legal determinations are subject to plenary review." *In re Continental Airlines*, 125 F.3d 120, 128 (3d Cir. 1997) (internal citations omitted); *accord In re Engel*, 124 F.3d 567, 571 (3d Cir. 1997).

The Government argues that the $4.8 million it deposited into the registry of the bankruptcy court and which the Government alleged it was entitled to set-off[3] against the $14.5 million owed by Continental, was not "property of the [bankruptcy] estate." The

---

[3] 11 U.S.C. § 553 which governs set-offs does not define the term. The right of set-off, as generally understood, simply means that "the debts of two persons who are mutually indebted may be set off against each other." Brian A. Blum, *Bankruptcy and Debtor/Creditor* § 22.2, at 348 (1993). "Its central premise is an ancient one well-grounded in practical logic: If A is indebted to B, and B is likewise indebted to A, it makes sense simply to apply one debt in satisfaction of the other rather than require A and B to satisfy their mutual liabilities separately." 5 *Collier on Bankruptcy* ¶ 553.01 (Lawrence P. King ed., 15th rev. ed. 1997).

Government contends that the bankruptcy court's confirmation of Continental's reorganization plan did not extinguish its right of set-off vis-a-vis the $4.8 million held in the court's registry.[4] The Government principally bases its argument on *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 116 S. Ct. 286, 133 L.Ed.2d 258 (1995), which it argues overrules this Court's holding in *United States v. Norton*, 717 F.2d 767 (3d Cir. 1983), heavily relied on by the bankruptcy court and the district court.

Norton held that a creditor's withholding of funds subject to a set-off violated the Bankruptcy Code's automatic stay provision,[5] and also adopted the viewpoint that set-off is not permitted *after* confirmation of a bankruptcy plan of reorganization. In *Norton*, under facts similar to those presented on this appeal, this court held that the Government could not offset an outstanding tax refund against an outstanding tax liability after confirmation of the debtor's plan. In their plan, as here, the debtors made no provision for set-off. Emphasizing that the Government never objected to the plan, we concluded that it would be unreasonable for the Government to retain the tax refund as security for the debtors' obligation. In-

---

[4] For purposes of this discussion it is unnecessary to determine whether the Government did have a valid right of set-off; thus, the right will be assumed.

[5] The automatic stay, 11 U.S.C. § 362(a), is "an injunction that arises by operation of law immediately upon the commencement of the bankruptcy case . . . . Its effect is to impose a wide-ranging prohibition on all activity outside the bankruptcy forum to collect pre-petition debts from the debtor or to assert or enforce claims against the debtor's pre-petition property or estate property." Blum, *Bankruptcy and Debtor/Creditor* § 16.1, at 231.

stead, we required the Government to pay over the refund and accept treatment under the plan as an unsecured creditor.

The Government primarily contends that this case is closely analogous to and governed by the recent decision of the United States Supreme Court in *Strumpf* and thus is not controlled by *Norton*. In *Strumpf*, the Supreme Court merely held that a bank's *pre-confirmation temporary* withholding of a debt that it owed a depositor who was in bankruptcy, in order to protect its set-off rights, did not violate the automatic stay. The Court explained that the bank's "temporary refusal to pay was neither a taking of possession of [the depositor/debtor's] property nor an exercising of control over it, but merely a refusal to perform its promise." *Id.* at 21, 116 S. Ct. at 290. *Norton*, therefore, is only overturned to the extent that it held that "*state* law . . . determine[s] when a set-off has occurred." 717 F.2d at 772 (emphasis added). Today, under *Strumpf*, "the question whether a set-off . . . has occurred is [now] a matter of *federal* law;" a bank's temporary withholding of funds on deposit subject to a set-off does not violate the automatic stay. 516 U.S. at 18-20, 116 S. Ct. at 289 (emphasis added). The Government's position, in this case, mischaracterizes and overemphasizes both the relevance and importance of *Strumpf*. It reaches this conclusion by incorrectly arguing that pursuant to *Strumpf*, because the $4.8 million was still held in the registry of the Court at the time Continental's reorganization plan was confirmed, "the funds plainly were not 'property of the estate' at that time." Thus, the Government's argument continues, when the court confirmed the plan, the funds did not vest "free

and clear" in Continental as property of the bankruptcy estate. Building on this premise, the Government concludes that the April 16, 1993 confirmation of Continental's plan did not extinguish GSA's right to set- off the $4.8 million owed to Continental against its $14.5 million in claims due its agencies.

As Continental points out, however, the Supreme Court in *Strumpf* expressly refused to address the issue of the effect of confirmation on set-offs, which is dispositive to the resolution of this appeal. In a footnote in *Strumpf*, the Supreme Court unequivocally "decline[d] to address [the] contention . . . that the confirmation of [a bankruptcy reorganization plan] preclude[s][the] exercise of [a] set-off right." 516 U.S. at 21 n. **, 116 S. Ct. at 290 n. **. This case, therefore, is not controlled by *Strumpf* because the Government here filed its motion to exercise its alleged set-off in the bankruptcy court almost six weeks *after* confirmation of Continental's reorganization plan (and over nine months after the district court held the Government liable to Continental for the $4.8 million in the *Alaska Airlines* case).

Finally, the Government's contention that the *Norton* court "incorrectly considered the funds held by the creditor to be property of the estate" which led to its "erroneous ruling that confirmation of the plan extinguishes a creditor's set-off rights" is without merit. (citing 11 U.S.C. §§ 1141(b), 1327, and *Norton*, 717 at 774). The Government's argument makes two critical mistakes and thus misses the cumulative effect of the *Norton* and *Strumpf* holdings. First, although *Norton* implicitly held that the funds withheld by the creditor subject to set-off were

"property of the estate," today under *Strumpf*, the relevant "property of the estate" is instead the bankrupt debtor's claim to the funds as opposed to the possession of the physical funds themselves.

Second, the relevant funds at issue in this case are clearly distinguishable from those in both *Norton* and *Strumpf*. In both of those cases, the creditor retained possession of the funds; here the Government deposited the $4.8 million into the registry of the court pending an appeal. As this Court has noted, such deposits are comparable to the res of a trust. The "court acts as trustee and is charged with the duty of determining the beneficiaries pursuant to the appeal. . . . [T]he [Government] has no beneficial interest [in the deposit[]) [while the court] holds the money as . . . trustee for the rightful owners when and if they are determined by the court." *Mid-Jersey Nat'l Bank v. Fidelity-Mortgage Investors*, 518 F.2d 640, 643-44 (3d Cir. 1975). Thus, contrary to the Government's assertion, its set-off rights in the funds did not remain unaffected by confirmation of the plan because the Government no longer retained an interest in them; under *Norton*, its set-off right was extinguished by the confirmation of the plan. Although the actual funds themselves may not have passed as property of the estate, upon confirmation of the plan, Continental did acquire a claim or interest in them subject only to final resolution of the Government's appeal. *Norton* continues to have vitality and survives *Strumpf*.

The Government argues before us, however, that to the extent that *Norton* may control and hold that the confirmation of the plan extinguishes all set-off rights not provided for in the plan, it was wrongly de-

cided. The Government asserts that the Bankruptcy Code's set-off provision in § 553 states in the clearest of terms that the rest of the Bankruptcy Code "does not affect" a creditor's right to set-off provided that the obligations between creditor and debtor are mutual and that both obligations arose prior to the commencement of the reorganization proceedings. Relying on 11 U.S.C. § 553(a), the Government, in effect, maintains that a pre-petition creditor's right to set-off may be exercised without regard to the status of the bankruptcy proceedings and the confirmation of the debtor's reorganization plan. The Government argues that *In re De Laurentiis Entertainment Group, Inc.*, 963 F.2d 1269 (9th Cir. 1992), supports its position. In *De Laurentiis*, the court considered the tension between 11 U.S.C. § 553 and 11 U.S.C. § 1141 of the Bankruptcy Code. Section 1141 provides for the discharge of pre-petition debts after completion of a bankruptcy proceeding.[6] It also provides that any as-

---

[6] 11 U.S.C. § 1141 provides in pertinent part:

> (a) Except as provided in subsections (d)(2) and (d)(3) of this section, the provisions of a confirmed plan bind . . . any creditor . . . whether or not such creditor . . . has accepted the plan.
>
> . . .
>
> (c) Except as provided in subsections (d)(2) and (d)(3) of this section and except as otherwise provided in the plan or in the order confirming the plan, after confirmation of a plan, *the property dealt with by the plan is free and clear of all claims and interests of creditors* . . . .
>
> (d)(1) Except as otherwise provided in this subsection, in the plan, or in the order confirming the plan, the *confirmation of a plan—*

sets retained under the administration of reorganization are free and clear of any pre-petition debts. 11 U.S.C. § 553[7] protects the right of a creditor to offset a mutual debt. After analyzing the statutory sections and the applicable cases in other jurisdictions, the *De Laurentiis* court concluded that § 553 must take precedence over § 1141. Although uncertain, it also believed that the language of § 553 "seems intended to control notwithstanding any other provisions of the Bankruptcy Code." 963 F.2d at 1276-77. The court, however, predicated its decision upon the particular facts in the case before it, including the creditor's diligent pursuit of its set-off claim before the bankruptcy court "during the entire period the reorganization plan was being considered. *Id.* at 1277. The court noted that the creditor, NBC, had filed a proof of claim and petition for relief from stay.

We believe that the material facts in *De Laurentiis* distinguish it from the case before us. We recognize that a right of set-off is preserved under § 553 in a bankruptcy proceeding but we believe that the right must be exercised by the creditor in timely fashion and appropriately asserted in accordance with other

---

(A) *discharges the debtor from any debt that arose before the date of such confirmation* . . . . (emphasis added).

[7] 11 U.S.C. § 553 provides in pertinent part:

(a) Except as otherwise provided in this section and in sections 362 and 363 of this title, *this title does not affect any right of a creditor to offset a mutual debt* owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . . . (emphasis added).

provisions of the Bankruptcy Code. Unlike the Government in this case, NBC, the creditor in *De Laurentiis*, timely filed its proof of claim in the bankruptcy court and claimed its right of set-off against its debt to the Debtor. NBC also filed a motion for relief from the automatic stay prior to confirmation of the plan. The Government did neither of these in this case. In the instant case, the plan of reorganization proceeded on the justifiable assumption that the reorganized debtor faced no set-off claim. On the other hand, in *De Laurentiis*, the bankruptcy court converted NBC's set-off claim into an adversary proceeding and NBC "pursued its claim diligently before the bankruptcy court at all times." *Id.* at 1271. There was no adversary proceeding here prior to plan confirmation, and the facts in both cases are materially different.

The Government also cites to *In re Davidovich*, 901 F.2d 1533 (10th Cir. 1990) and two bankruptcy court cases. *Davidovich* involved an arbitration debt to the debtor from his former law partner, and the debtor, under the facts of the case, had notice of the set-off claim. The court, however, only discussed the right of set-off under § 553 but made no analysis of the provisions of § 1141 of the Bankruptcy Code. As to the bankruptcy court cases, *In Re Wiegand*, 199 B.R. 639 (Bankr. W.D. Mich. 1996) relies largely on *De Laurentiis* only, and the facts of *In re Womack*, 188 B.R. 259 (Bankr. E.D. Ark. 1995), are distinguishable. *Womack*, unlike this case, involved a *secured debt* of the Government, income tax liability, payment of which was provided by the confirmed plan. The debtors had a refund due from the Government for an overpayment on a subsequent tax year. After the

confirmation of the plan, the Government sought to set-off the refund against the debt due it under the plan and the bankruptcy court permitted it. The bankruptcy court concluded that the set-off might in fact be of benefit to the debtors and to some of the creditors because the reduction of the claim of the United States under the plan will permit acceleration of payment to other creditors. *Id.* at 262. Because the plan provided for the ultimate payment of the debt due the Government, allowing the set-off merely accelerated its payment, and there was no need to discuss the conflict between § 553 and § 1141 of the Bankruptcy Code.

Thus, we are not persuaded by the cases relied on by the Government that § 1141 may be disregarded when a set-off is asserted. *Norton* did not extinguish non-secured set-off claims, nor do we, provided they are timely asserted. In the instant case, the Government would have the court treat a non-secured claim as a secured claim to the disadvantage of all other general creditors. The Government here has no statutory secured claims as it did in *Womack* for income tax liability. Furthermore, allowing the Government under the facts of this case to come forward after the plan of reorganization has been confirmed and *sua sponte* decide that it has a valid set-off without timely filing a proof of claim and asserting the set-off in the reorganization proceedings, has a probability of disrupting the plan of reorganization. It may also unnecessarily protract the bankruptcy proceedings and consume judicial resources. Furthermore, it is unfair to other creditors and the debtors, and can conceivably undermine the plan of

reorganization and the objectives and structure of the Bankruptcy Code.

Thus, because the Government attempted to exercise its set-off right *after* confirmation of the plan, the Government's remaining arguments are unpersuasive. *Norton* still controls in this Circuit and precludes the Government's exercise of any set-off right it may have had once Continental's plan was approved. As the Government correctly notes, "a panel of this court is bound to follow the holdings of published opinions of prior panels of this court unless overruled by the court en banc or the holding is undermined by a subsequent Supreme Court case." *Nationwide Ins. Co. v. Patterson*, 953 F.2d 44, 46 (3d Cir. 1991).

III.

To summarize, we reaffirm the ruling in *Norton* and hold that the right of a creditor to set-off in a bankruptcy reorganization proceeding must be duly exercised in the bankruptcy court before the plan of reorganization is confirmed; the failure to do so extinguishes the claim.

Accordingly, the judgment of the district court upholding the bankruptcy court's ruling that the

Government's set-off rights, if any, were extinguished upon confirmation of Continental's Plan of Reorganization will be affirmed. Costs taxed against the appellant.

A True Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 97-7109
Civil Action No. 93-cv-00485

IN RE: CONTINENTAL AIRLINES, DEBTOR

UNITED STATES OF AMERICA, APPELLANT

v.

CONTINENTAL AIRLINES

THOMAS E. ROSS, TRUSTEE

An Appeal from the United States District Court
for the District of Delaware

[Filed: March 23, 1998]

Before: COWEN, MCKEE and ROSENN, Circuit Judges.

ORDER AMENDING OPINION

The Opinion of the court filed in the above entitled case on January 20, 1998, is herewith amended as follows:

1) Slip opinion, page 4, second full paragraph, the first two sentences should now read as follows:

> The Government argues that the $4.8 million in funds it held at the time of confirmation and

> subsequently deposited into the registry of the bankruptcy court, and which the Government alleged it was entitled to set-off[] against the $14.5 million owed by Continental, was not "property of the [bankruptcy] estate." The Government contends that the bankruptcy court's confirmation of Continental's reorganization plan did not extinguish its right of set-off vis-a-vis the $4.8 million in funds because it still held them at the time of confirmation.[]

2) Slip opinion, page 6, line 7, delete "in the registry of the court" and substitute "by the Government."

3) Slip opinion, pages 6-7, revised and combine the last paragraph on page 6 and the first full paragraph of page 7 to read:

> Finally, the Government's contention that the *Norton* court "incorrectly considered the funds held by the creditor to be property of the estate" which led to its "erroneous ruling that confirmation of the plan extinguishes a creditor's set-off rights" is without merit. (citing 11 U.S.C. §§ 1141(b) and 1327, and *Norton*, 717 at 774). The Government's argument thus misses the cumulative effect of the *Norton* and *Strumpf* holdings. Although *Norton* implicitly held that the funds withheld by the creditor subject to set-off were "property of the estate" today under *Strumpf*, the relevant "property of the estate," is instead the bankrupt debtor's claim to the funds as opposed to the possession of the physical funds themselves. Even though the actual funds themselves may not have passed as property of the bankruptcy estate, upon confirmation of the plan, Continental did

acquire a claim or interest in them subject only to final resolution of the Government's appeal. Thus, contrary to the Government's assertion, its set-off rights in the funds did not remain unaffected by confirmation of the plan because, under *Norton*, its set-off right was extinguished by the confirmation of the plan. *Norton* continues to have vitality and survives *Strumpf*.

BY THE COURT:

/s/ MAX ROSENN
MAX ROSENN
Circuit Judge

March 23, 1998

A True Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

APPENDIX C

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE

Nos. 90-322 to 90-984
Civ.A. No. 93-485-LON

IN RE: CONTINENTAL AIRLINES, INC., ET AL., DEBTOR

UNITED STATES OF AMERICA, APPELLANT

v.

CONTINENTAL AIRLINES, INC., ET AL., APPELLEE

[Filed: Jan. 9, 1997]

ORDER

1. This matter comes before the Court on appeal from Orders of the United States Bankruptcy Court for the District of Delaware denying the United States's motion for an order directing the return of monies deposited with the Registry of the Bankruptcy Court and granting Continental's cross-motion for an order directing disbursement of the monies deposited with the Registry. [Docket Item ("D.I.") 14, at A-168 to A-174]. The matter was referred to the Honorable Mary Pat Trostle, United States Magistrate-Judge pursuant to 28 U.S.C. § 636(b) for the purpose of obtaining a report and recommendation to aid this Court in its disposition of this matter. [D.I. 20]. The Magistrate-Judge issued her Report and Recommendation recommending affir-

mance of the Orders of the Bankruptcy Court. [D.I. 22]. The Government filed objections to the Report and Recommendation. This Court will therefore conduct a de novo review of the Magistrate-Judge's Report and Recommendation. 28 U.S.C. § 636(b)(1).

2. On December 3, 1990, Continental filed a petition for reorganization under chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware. On April 16, 1993, the Bankruptcy Court entered an Order confirming Continental's Revised Second Amended Joint Plan of Reorganization ("Plan of Reorganization" or "Plan"). Prior to confirmation of the Plan of Reorganization, ten agencies of the United States filed proofs of claim against Continental. This appeal arises from the attempt by the United States to setoff certain funds the General Services Administration ("GSA") was ordered to pay to Continental in an unrelated matter against debts which Continental owed to these agencies.

3. In prior litigation, Continental and several other airlines commenced an administrative proceeding before the Comptroller General challenging GSA's policy and practice regarding government travel. The Comptroller General ruled in favor of the airlines, concluding that GSA had wrongfully withheld funds from the airline. GSA refused to abide by the ruling, claiming that the Comptroller General lacked constitutional authority to issue a binding decision. Consequently, the airlines filed suit in the United States District Court for the District of Columbia in *Alaska Airlines, Inc. et al. v. Richard Austin, et al.*, 801 F.Supp. 760 (D. D.C. 1992), to enforce the Comptroller's decision.

4. On August 11, 1992, the court ruled in the airlines favor and entered an injunction which, inter alia, ordered GSA to return money improperly withheld from the airlines. *See Alaska Airlines, Inc., et al. v. Richard Austin, et al.*, 801 F.Supp. 760 (D. D.C.1992), *rev'd in part on other grounds*, 8 F.3d 791 (Fed. Cir. 1993). Following the issuance of the injunction, the United States moved in the District Court of the District of Columbia for a stay pending its appeal. This motion was denied. The United States appealed this denial to the United States Court of Appeals for the Federal Circuit. In an Order dated February 10, 1993, the Federal Circuit also denied the United States's motion. On reconsideration, at the request of the United States, the Federal Circuit ordered GSA to pay the money withheld from Continental and three other airlines in bankruptcy proceedings into the registry of the respective bankruptcy courts rather than to the trustees. In accordance with the Federal Circuit's Order, on May 19, 1993, the United States deposited approximately $4.5 million in the Registry of the Bankruptcy Court for the District of Delaware.

5. On May 28, 1993, the United States moved in the Bankruptcy Court in the present action for an order directing the return of the money deposited in the Registry as a setoff against the debts owed by Continental to the various agencies of the United States that filed proofs of claims in this case. Continental opposed this motion and filed a cross-motion for disbursement of the funds. After a hearing, the Bankruptcy Court denied the United States's motion and granted Continental's cross-motion. This Court has

jurisdiction over the United States's appeal from these Orders pursuant to 28 U.S.C. § 158(a).

6. As a preliminary matter, the United States objects to this Court's referral of this case to the Magistrate-Judge. Pursuant to 28 U.S.C. § 636(b), this Court assigned this case to the Magistrate-Judge for the purpose of obtaining a report and recommendation to aid this Court in its decision of this matter. The United States asserts that it is improper for a district court to refer bankruptcy appeals to a magistrate-judge.

7. Resolution of this issue requires an examination of the modern procedural changes in the United States Bankruptcy Court system. The previous bankruptcy law, enacted as part of the Bankruptcy Reform Act of 1978 ("BRA"), expressly prohibited the district courts from referring appeals of bankruptcy court decisions to magistrate-judges. Under that system, 28 U.S.C. § 1334(c) provided: "A district court may not refer an appeal . . . to a magistrate or to a special master." This system also provided for three avenues of appeal from orders of bankruptcy judges: (1) to a panel of three bankruptcy judges; (2) to the United States district courts; or (3) directly to the courts of appeals, provided the parties agreed. *See* 1 Collier on Bankruptcy § 3.03(1)(a) (1996).

8. In response to the United States Supreme Court's decision in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), which raised doubts about the constitutionality of the bankruptcy court system established by the BRA, Congress amended the bankruptcy court system through the enactment of the Bankruptcy Amendments and Federal Judgeship Act of 1984 ("BAFJA"). The

BAFJA, inter alia, completely rewrote section 1334. By rewriting this section, Congress repealed the prohibition against referral to a magistrate-judge by omission. The BAFJA also reduced the avenues of appeal from the order of a bankruptcy judge from three to two. Under 28 U.S.C. § 158, a party may appeal an order of a bankruptcy court (1) to a district court; or (2) to panel of three bankruptcy judges.

9. The United States relies on the decisions in *Minerex Erdoel, Inc. v. Sina, Inc.*, 838 F.2d 781 (5th Cir.), *cert. denied sub.nom. Baker, Smith & Mills v. Minerex Erdoel, Inc.*, 488 U.S. 817 (1988), and *In re Elcona Homes Corp.*, 810 F.2d 136 (7th Cir. 1987) in challenging the propriety of referring this bankruptcy appeal to the Magistrate-Judge. These cases, however, are both distinguishable from the situation before the Court. In both of those cases, the district court referred the bankruptcy appeal to the magistrate-judge pursuant to 28 U.S.C. § 636(c)(1). *See Minerex*, 838 F.2d at 782 n. 1; *Elcona Homes*, 810 F.2d at 138. Under section 636(c)(1), a magistrate-judge, upon consent of the parties, "may conduct any or all proceedings in a jury or nonjury civil matter and order the entry of judgment in the case, when specifically designated to exercise such jurisdiction by the district court. . . ." Thus, in both of those cases, the magistrate-judge entered the final order in the case with no consideration or review from the district court. This was found to be contrary to the language in section 158 which clearly delineates the possible routes of appeal. The Court of Appeals for the Fifth Circuit opined:

> We are firmly convinced that § 158 can and must be taken at face value. Section 158 provides an

> intricate, balanced, and elaborate scheme for bankruptcy appeals carefully and thoughtfully crafted by Congress. Under that scheme appeals could be taken to (I) the District Court or (ii) to a panel of bankruptcy judges. No other type or kind of appeal was recognized, acknowledged, or permitted under that scheme. . . . It is reasonable to conclude that had Congress meant for its appeals scheme to include the potential for reference to a magistrate, Congress would have expressly so provided. Congress did not do so. Congress intended for its § 158 scheme to be comprehensive and complete in itself, and the avenues which it expressly provided to be the exclusive routes for bankruptcy appeals.

Minerex, 838 F.2d at 786 (footnote omitted); *accord Elcona Homes*, 810 F.2d at 139.

10. Conversely, in this case, the referral to the Magistrate-Judge was made pursuant to section 636(b). Unlike the situations described above, the Magistrate-Judge's decision is merely advisory, and the final order will be issued by this Court after de novo review of the Magistrate-Judge's Report and Recommendation. This distinction has been found to be critical by every post-BAFJA court reviewing this issue.[1] *See Virginia Beach Fed. Sav. and Loan Ass'n*

---

[1] In *Clarkson v. Cooke Sales and Serv. Co.*, 767 F.2d 817 (8th Cir. 1985), a case initiated before the enactment of the BAFJA, the Court of Appeals for the Eighth Circuit commented that referral to the magistrate for a report and recommendation was improper under the BRA jurisdictional statute, 28 U.S.C. § 1334, which expressly forbade assignment to the magistrate. Because the provision relied on by the Eight Cir-

v. Wood, 901 F.2d 849, 851 (10th Cir. 1990); *Hall v. Vance*, 887 F.2d 1041, 1045-46 (10th Cir. 1989); *In re Apex Oil Co.*, 146 B.R. 821, 822-23 (E.D. Mo. 1992). As the Court of Appeals for the Tenth Circuit stated,

> In this case, the district court's order specifically states that the hearing before the magistrate would be advisory and that its purpose was "to further define and focus the issues on appeal." The district court explicitly reserved for itself the final decision on appeal. The district court, therefore, properly availed itself of the magistrate's assistance to hasten its handling of the case. By reserving for itself the final decision of the appeal, it avoided the error of the district court in Elcona Homes. We, therefore, must reject the . . . contention that the district court's referral was improper.

Hall, 887 F.2d at 1046.

11. This Court agrees with each of the other courts that have addressed this issue that referral to the Magistrate-Judge for an advisory report and recommendation pursuant to section 636(b) is not improper under the BAFJA bankruptcy system. Under 28 U.S.C. § 636(b)(3), this Court may assign a magistrate "such additional duties as are not inconsistent with the constitution and laws of the United States." With the deliberate repeal of the prohibition against such referrals in the BAFJA, there is no longer a conflict between the practice of referring bankruptcy appeals to the magistrate-judge and an express provision of law. Moreover, because the district court

---

cuit was subsequently repealed by Congress, the reasoning in that case is inapposite to decision in this matter.

conducts a de novo review of the report and recommendation on referrals made pursuant to section 636(b), such referrals are not inconsistent with the section 158 language authorizing the district court to hear bankruptcy appeals. Accordingly, this Court concludes that it was not improper to refer this case to the Magistrate-Judge pursuant to section 636(b) for the purpose of obtaining an advisory report and recommendation to aid this Court in its decision of this matter.[2]

12. The United States also objects that the Magistrate-Judge applied an incorrect standard of review. This argument is primarily based on the United States assertion that the right of setoff under 11 U.S.C. § 553 is a matter of law, subject to de novo review. The United States is mistaken. The Court of Appeals for the Third Circuit has clearly stated that the grant of the equitable right of setoff rests in the discretion of the court. *United States ex rel. Internal Revenue Service v. Norton*, 717 F.2d 767, 772 (3d Cir. 1983). The Third Circuit opined:

> section 553 of the Bankruptcy Code neither defines "setoff" nor explains when a setoff has occurred. Thus, this provision is not an independent source of law governing setoff; it is generally understood as a legislative attempt to preserve the common-law right of setoff arising out of non-bankruptcy law. . . . The broad equitable discretion of courts in recognizing setoff rights

---

[2] Because the referral to the Magistrate-Judge in this case was made pursuant to section 636(b), this Court offers no opinion on the propriety of referring bankruptcy appeals to a magistrate-judge for final decision pursuant to section 636(c)(1).

> defined by the common law has been carried over . . . to section 553, whose language is permissive, not mandatory. "Its application, when properly invoked before a court, rests in the discretion of that court, which exercises such discretion under the general principles of equality." 4 Collier on Bankruptcy ¶ 553.02, at 553-11 (15th ed. 1983).

Id. (citations omitted); *accord In re Bevill, Bresler & Schulman Asset Management Corp.*, 896 F.2d 54, 57 (3d Cir. 1990) (equitable right of setoff is permissive, not mandatory and cannot be invoked in a case where the general principles of setoff would not justify it).

13. Moreover, the Magistrate-Judge's Report and Recommendation correctly states the standard of review for issues that arise in determining whether the United States has a right of setoff. Findings of fact by the Bankruptcy Court may be set aside only if the findings are "clearly erroneous." *See* Bankr. Rule 8013. The Bankruptcy Court's legal conclusions are subject to plenary review. *J.P. Fyfe, Inc. of Florida v. Bradco Supply Corp.*, 891 F.2d 66, 69 (3d Cir. 1989); *Brown v. Pennsylvania State Employees Credit Union*, 851 F.2d 81, 84 (3d Cir. 1988). Bankruptcy decisions involving the court's exercise of discretion are reviewed for abuse of discretion. *See In re Vertientes, Ltd.*, 845 F.2d 57, 59 (3d Cir. 1988). Accordingly, this objection by the United States is without merit.

14. Relying on *United States ex rel. Internal Revenue Service v. Norton*, 717 F.2d 767 (3d Cir. 1983), the Bankruptcy Court held that confirmation of Continental's Plan of Reorganization vitiated the United States's setoff rights, because upon confirmation, all property of the estate vested in Continental,

free and clear of any claims or interests. In her Report and Recommendation, the Magistrate-Judge agreed with the Bankruptcy Court's conclusion. The United States objected to the Magistrate-Judge's conclusion, asserting that confirmation of the Plan of Reorganization did not affect its right to setoff the funds deposited with the Registry of the Bankruptcy Court against debts owed by Continental to the United States.

15. In *United States ex rel. Internal Revenue Service v. Norton*, 717 F.2d 767 (3d Cir. 1983), the Internal Revenue Service sought to setoff a tax refund owed to Chapter 13 debtors against the debtors' pre-petition tax debts. The debtors' plan to pay off all of their creditors completely was confirmed by the Bankruptcy Court before the Internal Revenue Service withheld the refund. *Id.* at 774. The Court of Appeals for the Third Circuit concluded that the Internal Revenue Service was bound by the confirmed plan and not entitled to a setoff, because the plan did not expressly provide them with this right. *Id.* The Court opined:

> The provisions of a confirmed Chapter 13 plan bind the debtor and each creditor, whether or not the plan provides for the claim of a particular creditor. 11 U.S.C. § 1327(a) (1979). . . . Unless the plan provides otherwise, the property of the estate vests in the debtor upon confirmation and comes free and clear of any claim or interest of any creditor provided for by the plan. . . .
>
> Here, the Bankruptcy Court gave the IRS notice and an opportunity to have its objections to the proposed plan heard, an opportunity the IRS

> failed to take. Upon confirmation, the IRS became bound to that plan and to the payment schedule that would satisfy its claim in full.

Id. The court concluded that to permit the Internal Revenue Service to retain the refund as a setoff after confirmation of a plan that did not provide them with this right "would seriously compromise the powers of the Bankruptcy Court, the capacity of the debtors' to rehabilitate, and the equitable distribution that the Bankruptcy Code is designed to foster." *Id.*

16. The only distinction between the facts of *Norton* and this case is that in *Norton* the bankruptcy petition was filed under Chapter 13, whereas in this case the petition was filed under Chapter 11. Notwithstanding this distinction, both the Bankruptcy Court and the Magistrate-Judge were correct in concluding that this case is controlled by *Norton*. The provisions governing the effect of confirmation in Chapter 11 and Chapter 13 proceedings, sections 1141[3]

---

[3] Section 1141 provides:

> (a) Except as provided in subsections (d)(2) and (d)(3) of this section, the provisions of a confirmed plan bind the debtor . . . and any creditor, . . . whether or not the claim or interest of such creditor . . . is impaired under the plan and whether or not such creditor . . . has accepted the plan.
>
> (b) Except as otherwise provided in the plan or in the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.
>
> (c) Except as otherwise provided in subsections (d)(2) and (d)(3) of this section and except as otherwise provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors. . . .

and 1327[4] of the Bankruptcy Code respectively, are virtually identical. Both provisions bind the debtor and all creditors. *See* 11 U.S.C. §§ 1141(d)(1), 1327(a); *see also Norton*, 717 F.2d at 774. Under both provisions, unless the plan provides otherwise, the property of the estate vests in the debtor upon confirmation and comes free and clear of any claim or interest of any creditor provided for by the plan. *See* 11 U.S.C. §§ 1141(1), 1327(a); *see also Norton*, 717 F.2d at 774. Thus, the same considerations found to be dispositive by the Third Circuit in *Norton* are equally applicable here.

17. Accordingly, pursuant to *Norton*, a creditor's right to setoff is extinguished by a confirmed Chapter 11 plan, unless the plan explicitly preserves it. In the present case, Continental's plan did not provide the United States or any of its agencies with the right to setoff. In fact, not only does Continental's Plan fail to

---

Section 1141(d)(2) and (d)(3) are irrelevant for purposes of this issue.

[4] Section 1327 provides:

(a) The provisions of a confirmed plan bind the debtor and each creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan.

(b) Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.

(c) Except as otherwise provided in the plan or in the order confirming the plan, the property vesting the debtor under subsection (b) of this section is free and clear of any claim or interest of any creditor provided for by the plan.

provide the United States with setoff rights, it expressly prohibits the United States from setting off its claims without Continental's approval. Section 14.8 of the Plan entitled "Setoffs" provides: "Each Debtor . . . may, *but shall not be required to*, set off or recoup against any Claim . . ., claims of any nature whatsoever which such Debtor . . . may have against the holder of such Claim to the extent that such claim may be set off or recoup under applicable law. . . ." *See* [Docket Item 10, vol. II, Exh. 9, at 112] (emphasis added). Therefore, the United States does not have the right to setoff the funds deposited in the Registry of the Bankruptcy Court for the District of Delaware against debts owed by Continental to the United States or its agencies.

18. Because the conclusion that the United States's setoff rights, if any, were extinguished upon confirmation of Continental's Plan of Reorganization is dispositive of the issue presented here, the Court will not address any of the additional rulings of the bankruptcy court.

NOW, THEREFORE, IT IS ORDERED that:

The Orders of the Bankruptcy Court are affirmed.

APPENDIX D

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE

Civil Action No. 93-485-LON

CONTINENTAL AIRLINES, DEBTOR

UNITED STATES OF AMERICA, APPELLANT

v.

CONTINENTAL AIRLINES, APPELLEE

THOMAS E. ROSS, TRUSTEE

MAGISTRATE'S REPORT AND RECOMMENDATION

Dated: September 15, 1994

Wilmington, Delaware

TROSTLE, U.S. Magistrate-Judge

This matter comes before the Court on appeal from an Order of the United States Bankruptcy Court for the District of Delaware denying the United States' motion requesting the return of monies deposited with the Registry of the Court as a setoff against monies owed by Continental Airlines, Inc. ("Continental") to the United States and granting Continental's cross-motion for disbursement of the funds (D.I.

14, A-168, A-174); *In re Continental*, case nos. 90-932 - 90-984, Orders (September 30, 1993) (Balick, J.). In reviewing decisions of the Bankruptcy Court, the District Court sits as a Court of Appeals. 28 U.S.C. §§158(a), 1334.

FACTS AND PROCEEDINGS

Background Facts

The material facts in this case are not in dispute. On December 3, 1990, Continental and its affiliates (also referred to as "Debtors") filed petitions for reorganization under Chapter 11 of the Bankruptcy Code. On April 16, 1993, the Bankruptcy Court entered an Order confirming the Debtors' Revised Second Amended Joint Plan of Reorganization. From December 3, 1992 to April 16, 1993, ten agencies of the United States (also referred to as "Government") filed separate proofs of claim against Continental (D.I. 13 at 4). Four agencies used Continental's form, three used their own form, two used Bankruptcy Form 19 and one used Bankruptcy Form 10.

The four agencies using Continental's form were:

> (1) **United States Custom Service**, amended proof of claim filed on September 23, 1991 for $5,420,830; (2) **Equal Opportunity Commission**, amended proof of claim filed on September 23, 1991 for $3,500.00; (3) **Immigration and Naturalization Service**, amended proof of claim filed on September 16, 1992 for $5,859,851.52; and (4) **Department of Labor**, proof of claim filed on September 17, 1991 for $42,000.00.

Paragraph 7 of Continental's form provided an option for setoff rights, stating:

> this claim ( ) is not subject to any setoff or counterclaim of ( ) is subject to any setoff or counterclaim as follows:_____.

However, all four agencies left this paragraph blank (D.I. 13 at 4-5, D.I. 16 at 16).

The three agencies using their own proof of claim form were:

> (1) **Department of Agriculture ("DOA")**, proof of claim filed on February 19, 1991 for $94,266.71; (2) **Department of the Air Force**, amended proof of claim filed on October 27, 1991 for $155,572.89; and (3) **Federal Aviation Administration ("FAA").**

Paragraph 8 of the DOA's form provided

> the **filing of this claim is not to be construed . . . as a waiver of any . . . right of action or setoff** . . . that the United States or any agency . . . may have against the bankrupt, the receiver, the trustee, or any person (Emphasis added).

(D.I. 13 at 5). However, the Department of Air Force's form specifically provided "[t]here **are no setoffs or counterclaims to this said debt**" (D.I. 13 at 5). The FAA used a combination of Continental's form, its own form and the Settlement Agreement. Continental and the FAA negotiated several months with regard to the FAA's claim. The settlement reached on September 18, 1991 provided in part:

> Continental proposes that with respect to the FAA's civil penalty matter, [sic] Continental agrees to allow the FAA a general unsecured claim in the amount of $3,405,700.00 and to

> amend its schedules filed in the bankruptcy court to reflect same. That sum will be fixed as a an allowed claim and will affect the comprised resolution of all civil penalty matters involving FAA and Continental Airlines and all of the affiliated companies described above.

(D.I. 13 at 5-6). The bankruptcy court approved the Settlement Agreement on November 26, 1991. Pursuant to a court ordered extension, the FAA did not file its proof of claim until one day after execution of the Settlement Agreement, on November 27, 1991. The Settlement said nothing about setoff. Although the FAA did not check paragraph 7 of Continental's form regarding setoff, it stated "see Rider A attached hereto." Paragraph 9 and 10 of Rider A provided:

> 9. The amount of all payments on this claim has been credited and deducted for the purpose of making this Proof of Claim.
>
> 10. The **United States reserves its right to perfect any and all appropriate setoff.** (Emphasis added).

(D.I. 13 at 6-7).

> The two agencies using Bankruptcy Form 19 were:
>
> (1) **Peace Corps**, proof of claim filed on September 10, 1991 for $934.90; (2) **United States Postal Service**, proof of claim filed on January 22, 1991 for $42,275.00.

(D.I. 13 at 7).

The Drug Enforcement Administration filed a proof of claim using Bankruptcy Form 10 on August 23,

1991 for $837.50 (D.I. 13 at 7). Paragraph 6 of Form 10 provided:

> CREDITS AND SETOFFS: the amount of all payments on this claim has been credited or deducted for the purpose of making this proof of claim. In filing this claim, claimant has deducted all amounts that claimant owes to debtor.

(D.I. 13 at 7).

In prior litigation, Continental, along with other airlines, commenced an administrative proceeding before the Comptroller General challenging the Government Service Administration's ("GSA") policy and practice regarding Government travel. The Comptroller General ruled that GSA had wrongfully withheld funds from the airlines. As a result of GSA's failure to abide by the ruling, the airlines filed suit in the United States District Court for the District of Columbia. *Alaska Airlines, Inc., et al. v. Richard Austin, et al.*, 801 F.Supp. 760 (D.D.C. 1992) (Sporkin, J.), *aff'd. in part, rev'd. in part on other grounds*, 8 F.3d 791 (Fed.Cir. 1993). On August 11, 1992,[1] the District Court ruled in the airlines' favor. Pursuant to the Federal Circuit's Order, the Government deposited approximately $4,763,219.60 in the Registry of the Bankruptcy Court for the benefit of Continental (also referred to as "*Alaska Airlines* Fund").

---

[1] Of the eleven agencies (including GSA) involved in the litigation, only two filed proofs of claim after the August 11, 1992 *Alaska Airlines* decision. Of those two, one proof of claim explicitly asserted a right to setoff of the *Alaska Airlines* debt (GSA's proof of claim), and the other made no assertion claiming setoff against Continental (INS' proof of claim).

In addition to the ten agencies, GSA filed an amended proof of claim on May 28, 1993 for $517,042.09 and specifically asserted a right of setoff against the *Alaska Airlines* debts.

Continental submitted a Revised Second Amended Joint Plan of Reorganization ("Plan") to its creditors for a vote in January 1993. The IRS, DOA and FAA objected to the Plan. The IRS' objection only involved the priority of claims, scope of releases as to the officers and directors of the debtor companies and rights to offset tax claims owed by Continental, specifically against tax refunds. The DOA objected to the enforceability of the officer and director releases. These objections were resolved by stipulation. The FAA objected on the grounds that the provisions regarding satisfaction of the FAA's unsecured claims with stock in the reorganization debtor were inappropriate, FAA did not receive the same treatment as System One Holdings, Inc. (an affiliate of Continental), and officer and director releases rendered the Plan unconfirmable. These objections were also resolved by stipulation. Neither the IRS, DOA nor FAA's objections involved the right of setoff against the *Alaskan Airlines* debts.

On April 16, 1993, after notice and a hearing, the Bankruptcy Court confirmed the Plan. Thereafter, on May 28, 1993, the Government moved in the Bankruptcy Court for an Order offsetting the $4,763,219.60 deposited in the Registry as a setoff against monies owed by Continental to the United States. Continental opposed the motion and cross-motioned for disbursement of the funds. After a hearing on August 17, 1993, Judge Balick denied the United States' motion to allow offset and on September 14, 1993,

granted Continental's cross-motion for a disbursement of funds.[2] The United States appealed the two rulings to this Court. On October 19, 1993, the Court granted the United States a stay pending appeal of the Bankruptcy Court Order granting Continental's cross-motion for disbursement.

On appeal, the United States asserts that the Bankruptcy Court erred in denying its right of setoff. The Bankruptcy Court essentially held that (1) the agencies of the United States did not have mutuality for setoff purposes since each agency filed a separate proof of claim, and therefore, was a separate creditor under the Bankruptcy Code; (2) confirmation of Continental's plan of reorganization discharged Continental from its prepetition debts, thereby denying the United States a subsequent right of setoff; (3) FAA's claim was not available for setoff since it involved a postpetition settlement; (4) the United States waived its right of setoff by filing proofs of claims which did not assert a right of setoff; (5) the United States was estopped from asserting its right to setoff the FAA claim because of its conduct in negotiations leading up to the confirmation of Continental's plan of reorganization (D.I. 13, 14 at A-168). This Court shall address each issue in turn.

Basis of Appellate Jurisdiction

Section 158(a) of Title 28 of the United States Code provides that:

> The district courts of the United States shall have jurisdiction to hear appeals from final

---

[2] The orders embodying these rulings were issued on September 30, 1993 (D.I. 14, A-168, A-174).

> judgements, orders and decrees, and with leave of the court, from interlocutory orders and decrees, of bankruptcy judges entered in cases and proceedings referred to the bankruptcy judges under section 157 of this title . . .

28 U.S.C. 158(a).

Standard of Review

The proper standard to be applied by a district court reviewing the rulings of a bankruptcy court turns on the nature of the issues presented on appeal. Factual determinations of the bankruptcy court are entitled to deference and are not reversed unless found to be clearly erroneous. Bankruptcy Rule 8013; *In re Morrisey*, 717 F.2d 100, 104 (3d Cir. 1983). Legal conclusions of the bankruptcy court are subject to plenary review by the district court and are considered *de novo* on appeal. *Brown v. Pennsylvania State Employees Credit Union*, 851 F.2d 81, 84 (3d Cir. 1988). Bankruptcy decisions involving the court's exercise of discretion are reviewed for abuse of discretion. *In Re Trans World Airlines, Inc.*, 1993 WL 559245, *6 (D.Del., June 22, 1993) (Robinson, J.) (*citing In Re Vertientes, Ltd.*, 845 F.2d 57, 58-59 (3d Cir. 1988)); *In Re Continental Airlines*, 150 B.R. 334, 336 (D.Del. 1993) (Robinson, J.). Abuse of discretion will be found if the court's ruling was "founded on an error of law or clearly erroneous view of the facts or misapplication of law to the facts." *In Re Gioioso*, 979 F.2d 956, 959 (3d Cir. 1992). Further, a judge's discretion will be found to have been abused

> when the judicial action is arbitrary, fanciful or unreasonable, which is another way of saying that discretion is abused only where no reason-

> able man would take the view adopted by the trial court. If reasonable minds could differ as to the propriety of the action taken by the trial court, then it cannot be said that the trial court abused its discretion.

In Re Blackwell, 162 B.R. 117, 119 (E.D. Pa. 1993) (*citing In Re Shariyf*, 68 B.R. 604, 606-07 (E.D. Pa. 1986)). The application of 11 U.S.C. §553 is solely within the discretion of the court, under the general principles of equality. *United States v. Norton*, 717 F.2d 767, 772 (3d Cir. 1983), *superseded by statute on other grounds*. Since the Bankruptcy Court's decision denying setoff was within its discretion, the decision should be reviewed for abuse of discretion.[3] The Court's legal determination of mutuality under 11 U.S.C. §553 is subject to plenary review.

DISCUSSION

Right of Setoff

Setoff rights in bankruptcy are governed by 11 U.S.C. §553, which provides in relevant part:

---

[3] As stated, abuse of discretion is the standard for reviewing equitable decisions of the bankruptcy court. The bankruptcy court's equity powers are derived from §105(a) of the Bankruptcy Code, which provides:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this Title. No provisions of this Title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, *sua sponte*, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abusive process.

11 U.S.C. §105(a).

> (a) Except as otherwise provided in this Section and in Sections 362 and 363 of this Title, this Title does not effect any right of a creditor to **offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case**. . . . (Emphasis added).

11 U.S.C. §553(a). Section 553 does not create a right of setoff, it merely preserves in Bankruptcy law the right of setoff available at common law. *Matter of Bevill, Bresler & Schulman Asset Mgmt*, 896 F.2d 54, 57 (3d Cir. 1990) (*citing United States v. Norton*, 717 F.2d at 772).[4] This right of setoff is grounded in equity and fairness, and is a defense to a claim brought by a debtor against a creditor. *United States v. Norton*, 717 F.2d at 772; *In Re DeLaurentis Entertainment, Inc.*, 963 F.2d 1269, 1277 (9th Cir.), *cert. denied*, — U.S. —, 113 S.Ct. 330 (1992). *In Re G.S. Omni Corp.*, 835 F.3d 1317, 1318 (10th Cir. 1987). This equitable right of setoff depends on the existence of mutual debts and claims between the creditor and debtor. *Matter of Bevill*, 896 F.2d at 57. The common law doctrine of setoff essentially grants a creditor the right "'to offset a mutual debt owing by such creditor to the debtor' so long as both debts arose before commencement of the bankruptcy action and are indeed mutual." *In Re Davidovich*, 901 F.2d 1533, 1537 (10th Cir. 1990) (*quoting* 11 U.S.C. §553(a)).

A creditor carries the burden of proving that it has a right of setoff in bankruptcy. *In Re Ionosphere Clubs, Inc.*, 164 B.R. 839, 841 (Bankr. S.D.N.Y. 1994)

---

[4] Therefore, Section 553 cannot be considered an "independent source of law governing setoff," but a "legislative attempt" to preserve the common law right of setoff. *United States v. Norton*, 717 F.2d at 772; *Matter of Bevill*, 896 F.2d at 57.

(*citing First National Bank of Louisville v. Hurricane Elkhorn Coal Corp.*, 763 F.2d 188, 190 (6th Cir. 1985)). Although the right of setoff exists outside of bankruptcy, a creditor must satisfy the following conditions pursuant to §553(a):

> 1. A debt exists from the creditor to the debtor and that debt arose prior to the commencement of the bankruptcy case.
>
> 2. The creditor has a claim against the debtor which arose prior to the commencement of the bankruptcy case.
>
> 3. The debt and the claim are mutual obligations.

Braniff Airways, Inc. v. Exxon Co., U.S.A., 814 F.2d 1030, 1035 (5th Cir. 1987) (*quoting In Re Nickerson & Nickerson*, 62 B.R. 83, 85 (Bankr. D. Neb. 1986)). However, even if these three technical requirements are satisfied, the right of setoff must still be scrutinized in light of the Bankruptcy Code's goals and objectives.[5]

Requirement of a "Debt" Under §553 of the Bankruptcy Code

The right to setoff depends on the mutuality of prepetition "debts" owed to and owed by a creditor. *Ionosphere Clubs*, 164 B.R. at 841;[6] *In Re Drexel*

---

[5] Although the application of 11 U.S.C. §553 is permissive, not mandatory, and within the discretion of the court, it cannot be invoked where the general principles of setoff would not justify its application. *Matter of Bevill*, 896 F.2d at 57.

[6] The *Alaska Airlines* debt was also in dispute in *Ionosphere Clubs*, which involved the same Fund and many of the parties present in this case. As in the instant case, the Government in

Burnham Lambert Group, Inc., 113 B.R. 830, 839 (Bankr. S.D.N.Y. 1990). In the *Alaska Airlines* litigation, it was made abundantly clear by the District Court and Federal Circuit that the Fund belonged to the Debtors. The District Court specifically stated:

> Both the GAO and the Court have found that the Government arbitrarily and without justification has withheld from the Plaintiffs money clearly belonging to them. In essence, the **Government improperly has taken Plaintiffs' property from them without any legal basis for doing so.** (Emphasis added).

Ionosphere Clubs attempted to set off the *Alaska Airlines* Fund, an amount owed by GSA, against claims of the GSA and various other federal agencies. GSA, along with the other agencies, moved for relief from the automatic stay to set off funds owed by the Government to Eastern Air Lines for prepetition transactions against the prepetition debts owed by Eastern. The Bankruptcy Court for the Southern District of New York held that (1) the Government had no right to utilize the monies deposited with the registry of the court (*Alaska Airlines* Fund) to offset its debts because the Fund was not a "debt," but property of the debtor's estate; and (2) there was not mutuality of obligation between the governmental agencies for purposes of setoff. *Ionosphere Clubs*, 164 B.R. at 841-42.

The Trustee for Eastern Air Lines had also attempted to bind the Government to the Delaware Bankruptcy Court decisions in this case and in *In Re Trans World Airlines, Inc.*, No. 92-115 (Bankr. D. Del., September 30, 1993) (Balick, J.), which held that the United States could not setoff debts and obligations of different agencies. However, pursuant to the Supreme Court decision in *United States v. Mendoza*, 464 U.S. 154 (1984), offensive collateral estoppel did not apply to the Government. *Id.* at 842, n. 1.

Ionosphere Clubs, 164 B.R. at 841 (*quoting Alaska Airlines v. Austin*, No. Civ. 90-2879, 1992 WL 464711, at *2 (D.D.C. 1992)). On appeal, the Federal Circuit referred to the District Court's decision stating:

> The court also declared that because GSA holds funds withheld illegally, funds rightfully belonging to the airlines, to provide complete relief, and based on its conclusion that under the statutes the government had no right to withhold money, that money had to be returned.

Alaska Airlines, Inc. v. Johnson, 8 F.3d 791 (Fed. Cir. 1993). As concluded in *Ionosphere Clubs*, the *Alaska Airlines* Fund is "clearly **owned by**, as opposed to **owed** to the Debtor," and thus the Government has no right to utilize this Fund to offset its debts.

The Third Circuit analyzed the requirement of mutual "debts" under §553 in *Matter of Bevill*, 896 F.2d at 57-58. In *Bevill*, a creditor withheld income payments on government bonds and mortgage instruments from the debtor, and sought to avoid turning over these funds based on a claimed right of setoff against amounts owed to the creditor by the debtor. The Court determined that the Treasury Bonds, the coupon interest and the GNMA principal and interest were the property of the debtor, and the creditor was merely a trustee. Since the debtor was the "owner" of the funds, the creditor had no right to retain the payments, and therefore, there was no "debt" to be set off. *Id.* at 58. Applying this logic to the present case, the *Alaska Airlines* Fund cannot be considered a debt owed to Continental. It is undisputed that the *Alaska Airlines* Fund was money owned by, not owed to,

Continental. As a result, the Government should not be allowed to utilize the Fund to setoff its debts.

Mutuality of Obligation

Even if the *Alaska Airlines* Fund is considered a debt owed to Continental, the Government would still not be entitled to a setoff due to the lack of mutuality between the government agencies. As provided in §553(a) of the Bankruptcy Code, a prerequisite to the right of setoff depends on mutuality of obligation between the creditor and debtor, in other words, where the bankrupt and creditor owe a debt to each other. *Matter of Bevill*, 896 F.2d at 57. Therefore, in order to satisfy the mutuality requirement, all of the federal agencies together must be considered a single entity and an individual creditor for purposes of setoff. In this case, Continental asserts that the eleven agencies involved cannot be considered one entity for setoff purposes, and therefore not mutual. Judge Balick found that the agencies were separate creditors and not mutual for purposes of setoff (D.I. 14 at A-169, relying on the decision in *In Re Hancock*, 137 B.R. 835, 846-47 (Bankr. N.D. Ok. 1992)). In response, the United States asserts that Judge Balick erred in following the reasoning of *Hancock*, since it was clearly a minority opinion and "the single case not reversed on appeal which holds that agencies of the United States are not one entity for setoff purposes" (D.I. 13 at 14, Appellant's Br. [7]).

---

[7] The Government further asserts that regardless of whether *Hancock* was correctly decided, the court's rationale is inapplicable to this case because the transfer in *Hancock* was made prepetition and the court's concern was whether the transfer violated the policy of equality of distribution among creditors (D.I. 13 at 24, n. 7). In this case, Continental's Plan

In examining the decisions in *Ionosphere Clubs*, 164 B.R. at 842-843[8] and *In Re Lakeside Community Hosp., Inc.*, 151 B.R. 887, 892-93 (N.D. Ill. 1993), as well as a leading bankruptcy treatise, William L. Norton, Jr., 2 *Norton Law and Bankruptcy Practice* §33.05 at Supp. p. 11 (July 1993 Interim Supp.), §63:6 (January 1994) (the minority position cases holding that mutuality is lacking in such circumstances are based on well reasoned opinions),[9] there is at least one other case which has concurred with the reasoning in *Hancock*, and which has not been reversed.[10] In *Iono-*

---

was confirmed and distribution to the creditors fixed. Although the *Hancock* court discussed distribution to third parties, equality among creditors and preferential transfers, it clearly separated those issues from its analysis of the mutuality requirement for setoff purposes. After holding that the transfer was not a setoff but a preferential transfer, the court stated, "[a]lternatively, even if this transaction were of the general type which might be called 'setoff,' the question remains whether this transaction satisfies the usual conditions of setoff, and in particular the requirement of mutuality of obligations." *Hancock*, 137 B.R. at 845.

[8] The Court understands that this decision was rendered in February 1994, approximately three months after the parties in the present case briefed the issue, and therefore could not have been within the knowledge of the parties during briefing.

[9] Section 33.05 at Supp. p. 11 provides that "agencies within the same government" are "separate entities for purposes of mutuality under § 553."

[10] It should be noted that in contrast with the cases relied upon by the Government, the more recent authorities specifically addressing the issue of interagency setoff, including the decisions in *Hancock*, *Lakeside*, *Ionosphere*, as well as *Norton Law and Bankruptcy Practice*, §33.05, have concluded that agencies within the same government lack mutuality for purposes of setoff under § 553. *Cherry Cotton Mills* cannot be considered persuasive because it did not address the strict re-

sphere, the court recognized a "divergence of authority" regarding whether mutuality exists among governmental agencies for the purpose of setoff. Acknowledging that a number of courts had found that debts and claims incurred by different governmental agencies to be mutual, the court stressed that none of these cases contained an analysis of the issue relied upon the Supreme Court decision in *Cherry Cotton Mills, Inc. v. United States*, 327 U.S. 536 (1946). Although *Cherry Cotton* could be considered analogous to the facts in this case and *Ionosphere Clubs*, it was found distinguishable in that there were no other unsecured creditors and its conclusions were limited to the facts of the case or other similar nonbankruptcy matters.[11] *Ionosphere Clubs*, 164 B.R. at 842.

---

quirement of mutuality under §553, and the fact that a right of setoff exists outside bankruptcy does not automatically mean that the nonbankruptcy right complies with the mutuality requirement of §553. *See WJM, Inc. v. Massachusetts Dep't of Pub. Welfare*, 840 F.2d 996 (1st Cir. 1988). Further, in *Borsage v. United States Dep't of Educ.*, 5 F.3d 1414, 1419 n. 7 (11th Cir. 1993), the court addressed the issue of setoffs of debts owed and owing to different federal agencies outside of bankruptcy. In finding mutuality of obligations, the Eleventh Circuit noted that cases involving setoff in a bankruptcy context were inapposite in the nonbankruptcy context, since "the federal law of bankruptcy presents different and unique considerations, as payments made by one government agency to another during a bankruptcy proceeding may operate to the detriment of other creditors." *Id.* (*citing Hancock*, 137 B.R. 835 and *Lakeside*, 151 B.R. 887).

[11] In *Cherry Cotton Mills*, the Government sought to setoff a tax refund due a petitioner under the Agriculture Adjustment Act against a loan the petitioner owed to the Reconstruction Finance Corporation. *Cherry Cotton Mills*, 327 U.S. at 537.

As explained, §553 permits setoff by a "creditor" of a mutual debt owed by such creditor to the debtor. Section 101 of the Bankruptcy Code defines "creditor" as an "entity that has a claim against the debtor." 11 U.S.C. §101(10). An entity is understood to include a "governmental unit," 11 U.S.C. §101(15), and "governmental unit is defined as the "United States; State; . . . [or] department, agency, or instrumentality of the United States." 11 U.S.C. §101(27). In *Ionosphere*, the court applied the general rule of construction that each word in a statute should be given effect, and found the holding in *Lakeside* to be persuasive that "Congress intended that [governmental] units be treated as distinguishable and therefore not the same creditor within the provisions of the statute." *Ionosphere Clubs*, 164 B.R. at 842-43 (*quoting Lakeside*, 151 B.R. at 891); *Hancock*, 137 B.R. at 846. Relying on both the holding in *Hancock* and the language of the Bankruptcy Code, Judge Balick similarly determined that the governmental agencies were separate entities for the purposes of mutuality under §553. In reaching her decision, Judge Balick clearly relied on the "plain language" of §553 in conjunction with the definitional section 101 of the Bankruptcy Code.

In this instance, the federal agencies involved have distinct administrative structures, separate budgets and staffs, possess different rights, powers and privileges and have separate relationships with Continental. Moreover, each agency filed a separate proof of claim, on different forms, with some agencies explicitly waiving setoff rights and others reserving such rights. Although the Government claims that the agencies filed separate proofs of claims merely for

"administrative convenience" (D.I. 13 at 21-22), it fails to explain why some reserved a right of setoff, others waived the right and some did not assert a right either way. These agencies were clearly not acting as a joint body or a single governmental unit. In reviewing these facts, as well as the decisions in other jurisdictions, Judge Balick's finding that the requisite mutuality of obligations and claims did not exist so as to grant the Government the right to set off the *Alaska Airlines* Fund against debts owed by Continental is not an error of law.[12]

Confirmation of Continental's Plan

The Bankruptcy Court also cited alternative grounds for denying the United States' motion. Relying on *Norton*, the Court concluded that upon confirmation of Continental's Plan of Reorganization on April 16, 1993, all property of the estate vested in Continental, free of any claims or interests (D.I. 14 at A-170). Judge Balick specifically stated:

> Although *Norton* dealt with §1327(c) of the Bankruptcy Code, the **language of §1141(c) applicable to this case is identical,**[13] **and**

---

[12] Although the Government suggests that Judge Balick's findings regarding mutuality have limited bases in law, its argument appears to rest more on an abuse of discretion standard.

[13] 11 U.S.C. §1327(c) provides:

> Except as otherwise provided in the plan or in the order confirming the plan, the property vesting in the debtor under subsection (b) of this section is free and clear of any claim or interest of any creditor provided for by the plan.

11 U.S.C. §1141(c) provides:

> **Continental became vested in its property free of any claim of offset** by the Government. Whether they participate or not, all creditors, including the Government, are bound by the terms of Continental's confirmed Plan, and it is an **essential part of completing a bankruptcy proceeding, whether Chapter 11 or Chapter 13, that there be finality.** (Emphasis added).

(D.I. 14 at A-170). As the Bankruptcy Court reasoned, the essence of §§1141 and 1327 is to achieve finality and certainty. Judge Balick's reliance on *Norton* appears to be sound. Further, in *Norton*, the court emphasized the right to object to the confirmation of a plan by a party in interest. Although *Norton* dealt with a confirmed plan under Chapter 13 instead of Chapter 11, the same logic can be applied in both contexts.

The United States places heavy reliance on *DeLaurentis Entertainment*, 963 F.2d 1269. In *DeLaurentis*, the Ninth Circuit held that §553 took precedence over §1141. *Id.* at 1276-77. The court stated that if §1141 was to take precedence over §553, setoffs would only be allowed if written into a plan of reorganization, and §553 would essentially be meaningless. *Id.* at 1277. The Third Circuit's holding in *Norton*, however, is controlling and Judge Balick's application of that holding to this case (involving the confirmation of a Chapter 11 Plan) should not be con-

---

Except as provided in subsections (d)(2) and (d)(3) of this section and except as otherwise provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and all general partners in the debtor.

sidered an abuse of discretion. Moreover, as previously concluded, the *Alaska Airlines* Fund cannot be considered a "debt" owed to Continental since it was determined to be property of Continental's estate by the District Court of the District of Columbia and Federal Circuit. Because the Fund was "owned by" Continental, it should not be used to offset its debts.

Waiver/Post-Petition Obligations

The Bankruptcy Court further held that in failing to indicate or describe any right of setoff, the various agencies affirmatively waived any right to offset and therefore, pursuant to the settlement agreement between Continental and the FAA, Continental's obligation arose post-petition and was not mutual to the pre-petition obligation owed by GSA to Continental. It was within Judge Balick's discretion to conclude that a valid waiver existed. *In Re Metropolitan Intern., Inc.*, 616 F.2d 83, 86 (3d Cir. 1980) (*citing Linda Coal and Supply Co. v. Tasa Coal*, 204 A.2d 451 (Pa. Supr. 1964)). The language of the proof of claim forms is clear. By failing to express a right of setoff or by waiving such a right, the agencies should be considered to have waived any right to setoff. *In Re Mauch Chunck Brewing Co.*, 131 F.2d 48, 49 (3d Cir. 1942) (failing to assert the right of setoff or exhibiting conduct which is inconsistent with a subsequent claim of setoff shall be considered a waiver of the right). Moreover, the basis of the Bankruptcy Court's decision was rational, founded on sound legal principle, and therefore, should not be considered either legally erroneous or an abuse of discretion.

Finally, the Bankruptcy Court determined that the FAA's claims against Continental arose post-petition, due to the settlement agreement between the FAA

and Continental which converted the claims from pre-petition to post-petition. As a result, there was no longer any mutuality with regard to the pre-petition obligation owed by GSA to Continental. Since it has previously been decided that the FAA lacked the mutuality necessary to offset under §553, the issue of whether Continental's obligations arose post-petition or pre-petition need not be addressed.

CONCLUSION

For the reasons set forth herein, the Bankruptcy Court did not abuse its discretion in denying the United States' motion for setoff. Therefore, I recommend that the Bankruptcy Court's decision is AFFIRMED.

An Order consistent with this Report and Recommendation shall follow.

APPENDIX E

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

Case Nos. 90-932 to 90-984

IN RE: CONTINENTAL AIRLINES, INC., ET AL., DEBTORS

[Filed: September 30, 1993]

ORDER ON MOTION OF THE UNITED STATES FOR AN ORDER DIRECTING THE RETURN OF MONIES DEPOSITED WITH THE REGISTRY OF THE COURT

THIS MATTER comes on before the Court on the Motion of the United States for an Order Directing the Return of Monies Deposited With the Registry of the Court, and the Cross-Motion of Continental Airlines, Inc. ("Continental") for Disbursement of those funds to Continental. This matter having been briefed, and the Court having heard oral argument on August 17, 1993 and now being fully advised in the premises, hereby finds as follows:

The material facts in this case are not in dispute. At [a] hearing on August 17, 1993, the Court accepted the written chronology of events tendered by the United States (attached hereto), to which Continental stipulated. Continental noted two additional facts not disputed by the Government: first, that on September 10, 1990, the General Accounting Office ("GAO") handed down its decision in the administrative action brought by various airlines against the General

Services Administration ("GSA"), which decision upheld the position of the airlines; and second, that the GAO reaffirmed that decision on September 23, 1991. The proofs of claim, pleadings, and settlement agreements referenced in the briefs and argument are all matters of record with this Court or other courts, all of which this Court takes notice.

It is not disputed by the Government that a prerequisite to any right of offset that it may assert is mutuality of obligation. In this case, the obligation which the Government seeks to offset results from the judgment entered by the United States District Court for the District of Columbia in the case of *Alaska Airlines, et al. v. Richard Austin, et al.*, Case No. 90-2879 (Judge Sporkin), reported at 801 F.Supp. 760 (D.D.C. 1992), in which Richard G. Austin (head of the GSA), the GSA and the United States are Defendants. It is also undisputed that the GSA filed a proof of claim indicating a balance owed to Continental. Thus, the claims which the Government seeks to offset are all claims of other agencies, *e.g.* the United States Customs Service, the Immigration and Naturalization Service, the U.S. Postal Service, etc. Each of these entities filed separate proofs of claim. The Court elects to follow the reasoning of *In re Hancock*, 137 B.R. 835 at pp. 846, 847 (Bankr. D. Utah 1992), and holds that these agencies are separate creditors for purposes of 11 U.S.C. § 553, and are therefore not the same parties for establishing mutuality for purposes of setoff. *See also In re Lakeside Community Hospital, Inc.*, 151 B.R. 887 (N.D. Ill. 1993) (finding that separate state agencies are separate creditors under similar circumstances). Accordingly, the only creditor with the mutuality of obligation to be considered

for purposes of offset is the GSA, which, as noted, filed a proof of claim which indicated a balance owed *to* Continental. The Government's motion must therefore be denied.

There are other alternative and equally sufficient grounds for denial of the Government's motion. The holding in *United States v. Norton*, 717 F.2d 767 (3d Cir. 1983) also is controlling here. In *Norton*, the IRS lost its right to offset because the confirmed plan, which did not provide such a right, vested all property in the debtors, free and clear of all claims or interests, and the IRS had not objected to confirmation. Similarly, upon confirmation of Continental's Revised Second Amended Joint Plan of Reorganization on April 16, 1993, all property of the estate vested in the Debtors, free and clear of any claims or interest. Although *Norton* dealt with § 1327(c) of the Bankruptcy Code, the language of § 1141(c) applicable to this case is identical, and Continental became vested in its property free of any claim of offset by the Government. Whether they participate or not, all creditors including the Government, are bound by the terms of Continental's confirmed Plan, and it is an essential part of completing a bankruptcy proceeding, whether Chapter 11 or Chapter 13, that there be finality.

Additionally, the claim of the Federal Aviation Administration ("FAA") was disputed, and a settlement with respect to that claim was reached in which the FAA agreed that its claim was to be treated as a general unsecured claim in the amount of $3,405,700. This settlement was a compromise, as all or a portion of the FAA's claim might otherwise have been subordinated as a penalty. Further, the claim was treated

as a general unsecured claim for purposes of voting on the Plan. Finally, it was treated as a general unsecured claim by the FAA in its objection to confirmation of the Plan, which resulted in a modification of the Plan concerning officer and director releases. Had the FAA asserted then that it was fully secured by its purported offset right, as it does now, it may not have had standing to object to the releases. Therefore, the Government is estopped from asserting it now has a right of setoff, not only by the specific terms of the FAA settlement, but also by its subsequent actions in this case.

Similarly, the proofs of claim filed by the various agencies failed to indicate or described any right of setoff. As such, these agencies determined to vote on the Plan and participate in these proceedings as general unsecured creditors. The proofs of claim all require a statement regarding whether the creditor claims a right to offset. In all but one instance, the creditor agencies stated that their claims were not subject to setoff. In the one exception, the proof of claim did not identify the setoff, but merely stated that any right to setoff would be preserved. These statements in the proofs of claim constitute affirmative waivers of any right to offset.

Finally, to the extent any of such pre-petition claims have been settled by agreement reached post-petition, for example, the claim of the FAA, the obligation of Continental now arises post-petition under the settlement agreement. *See Cooper-Jarrett, Inc. v. Central Transport, Inc.*, 726 F.2d 93 (3d Cir. 1984). With regard to such claims, there is no longer any mutuality with regard to the pre-petition obligation owed by GSA to Continental.

In light of the above, the Court does not reach any other arguments made by Continental in opposition to the Government's Motion.

With regard to Continental's Cross-Motion for Disbursement of Funds to Debtors, the Court withholds its ruling until hearing on September 14, 1993. In the meantime, the Courts requests the Government to inform it of the status of this issue in the cases of *Eastern Airlines, Inc.* and *Pan Am.*

By agreement of the parties and by ruling of this Court, this Order shall not be deemed entered, and therefore not final for purposes of appeal, until the court also rules on Continental's Cross-Motion for Disbursement of Funds.

DATED this 30th day of September, 1993.

UNITED STATES BANKRUPTCY COURT

/s/ HELEN S. BALICK
HELEN S. BALICK
United States
Bankruptcy Judge

Facts

Dec 3, 1990	Continental et al file petitions	
Jan 22, 1991 -	Postal Service	$ 42,275.00
Feb 19, 1991 -	Agriculture	94,266.71
Mar 15, 1991 -	Air Force	31,394.12
Aug 01, 1991 -	EEOC	unknown
Aug 23, 1991 -	DEA	837.50
Sep 10, 1991 -	Peace Corps	934.90
Sep 12, 1991 -	GSA	(585,448.20)
Sep 12, 1991 -	INS	450,267.27
Sep 17, 1991 -	Labor	42,000.00
Sep 23, 1991 -	Customs	unknown
Sep 23, 1991 -	EEOC amended	3,500.00
Sep 27, 1991	**Bar Date**	
Oct 27, 1991 -	Air Force amended	155,572.89
Nov 26, 1991	Bankruptcy Court approves settlement with the FAA	
Nov 27, 1991 -	FAA 3,405,700.00	
Aug 12, 1992	District Court issues first order in Alaska Airlines	
Aug 13, 1992 -	Customs amended	5,420,830.00
Dec 16, 1992 -	INS 1st amended	5,859,851.52
Dec 16, 1992	District Court issues second order in Alaska Airlines (denying Government's motion for a stay pending appeal)	

Apr 12, 1993	Federal Circuit grants U.S. request for stay pending appeal to the extent that it permits U.S. to pay monies allegedly owed to Continental into the registry of the Court	
Apr 16, 1993	Bankruptcy Court confirms Continental's Plan	
May 04, 1993	U.S. applies for authority to deposit money with the registry of the Bankruptcy Court	
May 07, 1993	Bankruptcy Court grants motion of U.S.	
May 19, 1993	U.S. deposits $4,763,219.60 with the registry of the Bankruptcy Court	
May 28, 1993 -	GSA amended	(517,042.09)
Jul 02, 1993 -	INS 2nd amended	5,859,955.06
	Net Due United States	**14,508,803.27**

APPENDIX F

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

Case Nos. 90-932 to 90-984

IN RE: CONTINENTAL AIRLINES, INC., ET AL., DEBTORS

ORDER DIRECTING DISBURSEMENT OF FUNDS IN REGISTRY OF COURT TO CONTINENTAL AIRLINES, INC.

THIS MATTER coming on for hearing on September 14, 1993 on the Cross-Motion of Continental Airlines, Inc. for Disbursement of Monies to Debtors and the Court having heard the argument of counsel and now being fully advised, the Court hereby finds and orders that:

This Court has confirmed a plan or reorganization for the Debtors. The first major distribution has taken place thereunder. The Debtors are therefore in a position to seek a final decree in this matter with jurisdiction retained by this Court only as specified in the plan. Since the Debtors have emerged from Chapter 11, Continental Airlines, Inc. is no longer a "bankrupt carrier." Although, at the Court's request, the Court has been informed that similar funds in the cases of Eastern Airlines and Pan Am have not been paid over to the airlines, these cases are distinguishable because they are liquidations, and as such, the carriers are not in a position to reimburse the Government should the Court of Appeals reverse the District Court in the *Alaska Airlines* litigation. The Court understands from the Government's coun-

sel that all other airlines except TWA have been paid by the Government. Since Continental Airlines is no longer in Chapter 11, it should not be treated any differently than the other operating airlines that have been paid; it is therefore

ORDERED that all funds deposited in the Registry of the Court with Wilmington Trust pursuant to the Unopposed Application to Deposit Funds with the Registry of the Court filed by the United States and this Court's Order granting the same, along with all interest accrued thereon, shall be disbursed to Continental Airlines, Inc. forthwith.

DATED this 30th day of September, 1993.

/s/ HELEN S. BALICK
HELEN S. BALICK
United States
Bankruptcy Judge

APPENDIX G

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 97-7109

IN RE: CONTINENTAL AIRLINES, DEBTOR

UNITED STATES OF AMERICA, APPELLANT

v.

CONTINENTAL AIRLINES

THOMAS E. ROSS, TRUSTEE

SUR PETITION FOR REHEARING

Before: BECKER, Chief Judge, SLOVITER, STAPLETON, MANSMANN, GREENBERG, SCIRICA, COWEN, NYGAARD, ALITO, ROTH, MCKEE, RENDELL and ROSENN*, Circuit Judges

The petition for rehearing filed by appellant having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not

---

* As to Panel Rehearing.

having voted for rehearing by the court en banc, the petition for rehearing is denied.

By the Court,

/s/ ROBERT E. COWEN
ROBERT E. COWEN
Circuit Judge

Dated: March 23, 1998

APPENDIX H

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 97-7109
Civil Action No. 93-cv-00485

IN RE: CONTINENTAL AIRLINES, DEBTOR

UNITED STATES OF AMERICA, APPELLANT

v.

CONTINENTAL AIRLINES

THOMAS E. ROSS, TRUSTEE

An Appeal from the United States District Court
for the District of Delaware

Argued December 2, 1997
(Opinion Filed January 30, 1998)

Before: COWEN, MCKEE and ROSENN, Circuit Judges

Present: COWEN, MCKEE and ROSENN, Circuit Judges

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the District of Delaware and was argued by counsel December 2, 1997.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court entered January 16, 1997, be, and the same is hereby affirmed. Costs taxed against appellant. All of the above in accordance with the Opinion of this Court.

ATTEST:

/s/ Illegible
Clerk

Dated: January 20, 1998

Certified as a true copy and issued in lieu
of a formal mandate on March 31, 1998

Test: /s/ Illegible

Chief Deputy Clerk, United States Court of Appeals for the Third Circuit

APPENDIX I

Section 553 of Title 11, United States Code, provides:

§ 553. Setoff

(a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, except to the extent that—

(1) the claim of such creditor against the debtor is disallowed;

(2) such claim was transferred, by an entity other than the debtor, to such creditor—

(A) after the commencement of the case; or

(B)(i) after 90 days before the date of the filing of the petition; and

(ii) while the debtor was insolvent; or

(3) the debt owed to the debtor by such creditor was incurred by such creditor—

(A) after 90 days before the date of the filing of the petition;

(B) while the debtor was insolvent; and

(C) for the purpose of obtaining a right of setoff against the debtor.

(b)(1) Except with respect to a setoff of a kind described in section 362(b)(6), 362(b)(7), 362(b)(14), 365(h), 546(h), or 365(i)(2) of this title, if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of—

(A) 90 days before the date of the filing of the petition; and

(B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.

(2) In this subsection, "insufficiency" means amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim.

(c) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

Section 1141 of Title 11, United States Code, provides:

§ 1141. Effect of confirmation

(a) Except as provided in subsections (d)(2) and (d)(3) of this section, the provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such creditor, equity security holder, or general partner is impaired under the plan and whether or not such creditor, equity security holder, or general partner has accepted the plan.

(b) Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.

(c) Except as provided in subsections (d)(2) and (d)(3) of this section and except as otherwise provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor.

(d)(1) Except as otherwise provided in this subsection, in the plan, or in the order confirming the plan, the confirmation of a plan—

(A) discharges the debtor from any debt that arose before the date of such confirmation, and any debt of a kind specified in section

502(g), 502(h), or 502(i) of this title, whether or not—

(i) a proof of the claim based on such debt is filed or deemed filed under section 501 of this title;

(ii) such claim is allowed under section 502 of this title; or

(iii) the holder of such claim has accepted the plan; and

(B) terminates all rights and interests of equity security holders and general partners provided for by the plan.

(2) The confirmation of a plan does not discharge an individual debtor from any debt excepted from discharge under section 523 of this title.

(3) The confirmation of a plan does not discharge a debtor if—

(A) the plan provides for the liquidation of all or substantially all of the property of the estate;

(B) the debtor does not engage in business after consummation of the plan; and

(C) the debtor would be denied a discharge under section 727(a) of this title if the case were a case under chapter 7 of this title.

(4) The court may approve a written waiver of discharge executed by the debtor after the order for relief under this chapter.

(2)

No. 98-130

FILED
SEP 2 1998
OFFICE OF THE CLERK
SUPREME COURT, U.S.

In The

Supreme Court of the United States

October Term, 1997

UNITED STATES OF AMERICA,

Petitioner,

v.

CONTINENTAL AIRLINES,
THOMAS E. ROSS, TRUSTEE,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

CHRISTIAN C. ONSAGER
Counsel of Record
GORDON B. CONN JR.
MICHAEL J. PANKOW
FAEGRE & BENSON, LLP
2500 Republic Plaza
370 Seventeenth Street
Denver, CO 80202
(303) 592-9000
Attorneys for Respondent Continental Airlines, Inc.

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

56 pp

QUESTION PRESENTED

Whether Petitioner may require Respondent to "set off" against funds in the court registry (a) despite the finding below that Respondent owns the funds and no debt exists to set off; (b) despite the express terms of Respondent's confirmed plan of reorganization barring any setoff without Respondent's consent; (c) despite vesting of the funds free of Petitioner's claims under 11 U.S.C. § 1141 and the confirmation order, which Petitioner did not appeal; (d) despite findings below that Petitioner waived any right by lack of timely pursuit, by conduct disclaiming such rights, and by specific agreement; and (e) despite lack of mutuality required by 11 U.S.C. § 553.

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

TABLE OF AUTHORITIES iv

I. STATEMENT OF THE CASE 1

II. REASONS NOT TO GRANT CERTIORARI 3

A. NO CIRCUIT COURT DECISIONS ARE IN CONFLICT 3

B. THE COURT BELOW CORRECTLY CONSTRUED *STRUMPF* 6

C. INDEPENDENT GROUNDS SUPPORT THE DECISION BELOW 7

1. Petitioner Cannot Set Off Against Funds Which Continental Owns 7

2. Continental's Plan Specifically Prohibits Setoff without Continental's Consent .. 8

3. The United States Waived Its Right of Setoff 11

4. The Obligations Here Lack the Mutuality Required for Setoff 13

D. THE THIRD CIRCUIT CORRECTLY DECIDED THE CASE 15

III. CONCLUSION 18

APPENDIX

Stipulated Withdrawal of United States Internal Revenue Service's Objection to Debtors' Second Amended Plan of Reorganization .....Resp. App. 1a

TABLE OF CONTENTS – Continued

Page

Stipulation By and Between the United States of America and the Debtors as to Resolution and Withdrawal of Certain Objections to Debtors' Revised Second Amended Plan of Reorganization, as Modified ..... Resp. App. 8a

Settlement Agreement Between the Federal Aviation Administration and Continental Airlines, et al. ..... Resp. App. 11a

Excerpts from Debtors' Revised Second Amended Joint Plan of Reorganization Under Chapter 11 of the United States Bankruptcy Code ..... Resp. App. 17a

Excerpts from Findings of Fact, Conclusions of Law and Order Confirming the Debtors' Revised Second Amended Joint Plan of Reorganization, as Modified, Under Chapter 11 of the United States Bankruptcy Code and Granting Related Relief ..... Resp. App. 22a

11 U.S.C. §§ 101(10), (15), (27) ..... Resp. App. 27a

11 U.S.C. § 506 ..... Resp. App. 27a

TABLE OF AUTHORITIES

Page

CASES

Alaska Airlines, Inc. v. Austin, 801 F. Supp. 760 (D.D.C.), *aff'd*, 8 F.3d 791 (Fed. Cir. 1993) 1, 4, 6, 7, 8, 14

Alaska Airlines, Inc. v. Johnson, 8 F.3d 791 (Fed. Cir. 1993) 8

Bailey v. United States, 516 U.S. 137 (1995) 16

Cherry Cotton Mills, Inc. v. United States, 327 U.S. 536 (1946) 14, 15

Citizens Bank of Maryland v. Strumpf, 516 U.S. 16 (1995) 6, 7, 10, 17

Cumberland Glass Mfg. Co. v. DeWitt and Co., 237 U.S. 447 (1915) 12

Heins v. Ruti-Sweetwater, Inc. (In re Ruti-Sweetwater, Inc.), 836 F.2d 1263 (10th Cir. 1988) 9

In re Apex Int'l Management Serv., Inc., 155 B.R. 591 (Bankr. M.D. Fla. 1993), *aff'd*, 1996 WL 172210 (M.D. Fla. 1996) 11, 13

In re Bakersfield Westar Ambulance, Inc., 123 F.3d 1243 (9th Cir. 1997) 7

In re Barton Industries, Inc., 104 F.3d 1241 (10th Cir. 1997) 8

In re Be-Mac Transport Company, Inc., 83 F.3d 1020 (8th Cir. 1996) 16

In re Bevil, Bresler & Shulman Asset Management Corp., 896 F.2d 54 (3rd Cir. 1990) 17

In re Brenner, 189 B.R. 121 (Bankr. N.D. Ohio 1995) 9

TABLE OF AUTHORITIES – Continued

Page

In re Britton, 83 B.R. 914 (Bankr. E.D.N.C. 1988)..11, 14

In re Butler, 61 B.R. 790 (Bankr. S.D. Fla. 1986)..... 11

In re Calore Express Co., 199 B.R. 424 (Bankr. D. Mass. 1996) 11

In re Cascade Roads, Inc., 34 F.3d 756 (9th Cir. 1994) 13

In re Corbett, 124 F.3d 82 (2d Cir. 1997) 8

In re Custom Center, Inc., 163 B.R. 309 (Bankr. E.D. Tenn. 1994)..... 13

In Re Davidovich, 901 F.2d 1533 (10th Cir. 1990) 5

In re De Laurentiis Entertainment Group, Inc., 963 F.2d 1269 (9th Cir.), *cert. denied*, 506 U.S. 918 (1992) 3, 4, 5, 6, 11, 16

In re Gehrke, 158 B.R. 465 (Bankr. N.D. Iowa 1993) 13

In re HAL, Inc., 122 F.3d 851 (9th Cir. 1997)..... 14

In re Hancock, 137 B.R. 835 (Bankr. N.D. Okla. 1992)..... 14

In re Holder, 182 B.R. 770 (Bankr. M.D. Tenn. 1995) 13

In re Holly's, Inc., 190 B.R. 297 (Bankr. W.D. Mich. 1995)..... 12

In re Ionosphere Clubs, Inc., 164 B.R. 839 (Bankr. S.D.N.Y. 1994) 6, 8

TABLE OF AUTHORITIES – Continued

Page

In re Lakeside Community Hosp., Inc., 151 B.R. 887 (N.D. Ill. 1993) 13

In re Lykes Bros. Steamship Co., 217 B.R. 304 (Bankr. M.D. Fla. 1997) 9, 10

In re Mauch Chunk Brewing Co., 131 F.2d 48 (3rd Cir. 1942) 11

In re Metropolitan International, Inc., 616 F.2d 83 (3rd Cir. 1980) 11

In re Penn Cen. Trans. Co., 486 F.2d 519 (3rd Cir. 1973) (*en banc*), *cert. denied sub nom., Chicago and North Western Transp. Co. v. Baker*, 415 U.S. 990 (1974), *and cert. denied sub nom., Baker v. Indiana Harbor Belt R.R. Co.*, 415 U.S. 990 (1974) 10

In re Penrod, 50 F.3d 459 (7th Cir. 1995) 9, 15, 16

In re Public Service Co. of New Hampshire, 884 F.2d 11 (1st Cir. 1989) 12

In re Szostek, 886 F.2d 1405 (3rd Cir. 1989) 9

In re USA Diversified Products, Inc., 196 B.R. 801 (N.D. Ind. 1996) 7

In re Vertientes, Ltd., 845 F.2d 57 (3rd Cir. 1988) 11

In re Village Craftsmen, Inc., 160 B.R. 740 (Bankr. D.N.J. 1993) 4, 16

In re Wells, 125 B.R. 297 (Bankr. D. Colo. 1989) 11

Jones v. Keene Corp., 933 F.2d 209 (3rd Cir. 1991) 9

Meridian Bank v. Allen, 958 F.2d 1226 (3rd Cir. 1992) 11

TABLE OF AUTHORITIES – Continued

Page

Republic Supply Co. v. Shoaf, 815 F.2d 1046 (5th Cir. 1987) 9

Stoll v. Gottlieb, 305 U.S. 165, *reh'g denied*, 305 U.S. 675 (1938) 9

Taylor v. Freeland & Kronz, 503 U.S. 638 (1992) 9, 16

Trulis v. Barton, 107 F.3d 685 (9th Cir. 1995) 8

Turner v. Small Business Administration, 84 F.3d 1294 (10th Cir. 1996) (*en banc*) 14

U.S. v. Norton, 717 F.2d 767 (3rd Cir. 1983) ...3, 4, 5, 9, 10

United States Dept. of Air Force v. Carolina Parachute Corp., 907 F.2d 1469 (4th Cir. 1990) 9

Wallis v. Justice Oaks II, 898 F.2d 1544 (11th Cir. 1990), *cert. denied*, 498 U.S. 959 (1990) 9

STATUTES

11 U.S.C. § 101(5) 15

11 U.S.C. § 101(10) 13

11 U.S.C. § 101(15) 13

11 U.S.C. § 101(27) 13, 15

11 U.S.C. § 1129(b) 17

11 U.S.C. § 1141 5

11 U.S.C. § 1141(a) 3, 10

11 U.S.C. § 1141(c) 3, 6, 11, 15

11 U.S.C. § 1327 9

11 U.S.C. § 1327(a) 3

TABLE OF AUTHORITIES – Continued

Page

11 U.S.C. § 362(a) 6
11 U.S.C. § 506 ..... 16, 17
11 U.S.C. § 506(a) 15, 16
11 U.S.C. § 506(b) 17
11 U.S.C. § 524 5
11 U.S.C. § 541 7
11 U.S.C. § 553 ..... 3, 13, 14, 16, 17
11 U.S.C. § 553(a) 13
31 U.S.C. § 3716 14

OTHER

5 Collier on Bankruptcy ¶ 553.08[2] (15th ed. 1997) 5
7 Collier on Bankruptcy ¶ 1129.05[2] (15th ed. 1997) 17

I. STATEMENT OF THE CASE

In the 1980s, the Government Services Administration ("GSA") adopted audit procedures to force airlines to fly Federal Government travelers at below market fares and unilaterally withheld millions of dollars of alleged "overcharges." Several airlines including Continental challenged the GSA's procedures before the Comptroller General who found in September 1990 that GSA's methods were improper. When GSA claimed it need not obey a decision of the Comptroller General, the airlines sued in federal district court for enforcement. *See Alaska Airlines, Inc. v. Austin*, 801 F. Supp. 760 (D.D.C.), *aff'd*, 8 F.3d 791 (Fed. Cir. 1993). The United States did not assert any defense of setoff in the case.

Continental filed its petition under Chapter 11 of the Bankruptcy Code in December 1990. Ten separate federal agencies, including the GSA, filed proofs of claim. Four agencies affirmatively disclaimed any setoff right. Only three, the Department of Transportation ("DOT"), the Federal Aviation Administration ("FAA"), and the Internal Revenue Service ("IRS"), claimed a right of setoff. None asserted a setoff right related to the funds wrongfully withheld by the GSA. (*See* Petitioner's Appendix (hereinafter "App.") at 32a-35a, 55a.) The United States remained silent regarding any claim of setoff before both the District Court and the Bankruptcy Court.

Subsequently, the Comptroller General reaffirmed his decision, but the GSA still refused to obey. In August 1992, the U.S. District Court, finding that "[i]n essence, the Government improperly has taken Plaintiffs' property

from them without any legal basis for doing so," entered an injunction requiring GSA to return the moneys wrongfully withheld, including $4,636,639.35 withheld from Continental. *Id.* at 42a. The GSA appealed and sought a stay. In lieu of a stay, the Federal Circuit Court of Appeals permitted GSA to pay Continental's money into the Bankruptcy Court registry for further disposition. (*See* App. at 20a.)

Continental submitted its Revised Second Amended Joint Plan of Reorganization (the "Plan") for approval in January 1993. Under § 14.8 of the proposed Plan, Continental alone retained the election to set off or recoup against any claim. (*See* Respondent's Appendix (hereinafter "Resp. App.") at 20.)

The IRS, the Department of Agriculture ("USDA") and the FAA each objected to the Plan. Although the District Court had ordered GSA to return the $4.6 million over eight months before, only the IRS objected to the Plan's provisions regarding setoff. Continental agreed to allow setoff against any taxes owed by Continental, but not to any other right to setoff with respect to any other claim. (*See* Resp. App. at 3a.) The objections of the USDA and the FAA did not mention setoff and were also resolved by stipulation. (*See* Resp. App. at 8a-10a.) The FAA had previously agreed to treatment of its claim as a general unsecured claim only, which agreement was embodied in § 14.14(b) of the Plan. (*See* Resp. App. at 21a.)

On April 16, 1993, the Bankruptcy Court confirmed the Plan as modified. Its order became final and nonappealable. On May 28, 1993, the U.S. moved the Bankruptcy Court to allow it to deduct the various claims filed by the ten agencies from the funds deposited with the registry of the Bankruptcy Court. The Bankruptcy Court denied the motion and ordered the funds released to Continental. On appeal, the District Court and the Third Circuit Court of Appeals affirmed.

II. REASONS NOT TO GRANT CERTIORARI

A. NO CIRCUIT COURT DECISIONS ARE IN CONFLICT

Section 1141(c) of the Bankruptcy Code vests all property of the estate in the debtor "free and clear of all claims and interests of creditors" upon confirmation of a plan of reorganization. Consistent with the statute, Continental's Plan and the order confirming it provide that all property of its estate vests in the reorganized entity "free and clear." (*See* Resp. App. at 19a and 25a.) The United States did not object to this language, the Confirmation Order, or Plan language specifically reserving discretion over the right to setoff to Continental. Based in part on §§ 1141(a) and (c) of the Bankruptcy Code, the courts below held that the setoff rights claimed by the United States were barred.

Only two Circuit Courts have addressed the interplay of § 553 and § 1141(c) or its counterpart in chapter 13, § 1327(a): the Third Circuit in this case and in *U.S. v. Norton*, 717 F.2d 767, 772 (3rd Cir. 1983) and the Ninth Circuit in *In re De Laurentiis Entertainment Group, Inc.*, 963

F.2d 1269 (9th Cir.), *cert. denied*, 506 U.S. 918 (1992). Although differing in result, their reasoning does not conflict.

The United States argues that the Third Circuit should have followed the Ninth Circuit's ruling in *De Laurentiis* instead of its prior decision in *Norton*. However, the Third Circuit below correctly distinguished *De Laurentiis*, noting that the Ninth Circuit explicitly predicated its opinion on the specific facts before it. In *De Laurentiis*, the creditor timely filed a proof of claim asserting setoff, requested relief from the automatic stay prior to confirmation to accomplish the setoff, was a party to an adversary proceeding before the bankruptcy court regarding its setoff rights, and "pursued its claim diligently before the bankruptcy court at all times." *De Laurentiis*, 963 F.2d at 1271.

In contrast, petitioner failed to assert or disclaimed setoff rights in its proofs of claims. The United States never counterclaimed in *Alaska Airlines* nor moved for relief from stay or asserted setoff prior to plan confirmation in the bankruptcy case. At confirmation, the United States negotiated a right of setoff solely in relation to taxes. Moreover, whereas the *De Laurentiis* plan was silent as to setoff, Continental's confirmed Plan specifically ceded control of the election to set off a claim to the reorganized debtor.

De Laurentiis was based expressly on the unfairness that would result if a creditor's setoff rights were extinguished notwithstanding the contrary expectation of all parties at time of confirmation. *Id.* at 1277. *Accord In re Village Craftsmen, Inc.*, 160 B.R. 740, 798 n.3 (Bankr. D.N.J.

1993). The facts in the present case are markedly different: the court below found that Continental's Plan "proceeded on the justifiable expectation that the reorganized debtor faced no set-off claim." (*See* App. at 11a.)

Petitioner also attempts to manufacture a conflict with the Tenth Circuit's conclusion in *In Re Davidovich*, 901 F.2d 1533 (10th Cir. 1990). *Davidovich* addressed whether a debtor's discharge under Bankruptcy Code § 524 extinguished the right to setoff in a Chapter 7 liquidation case, a ground not argued by Continental below. As the Third Circuit noted, *Davidovich* does not concern § 1141 and the effect of confirmation of a plan. (*See* App. at 11a.) *Davidovich* and the decision below are neither related nor in conflict.

For these reasons, the "leading commentator" on bankruptcy cited by the United States stated:

> In *Norton* the IRS may have waived its right to keep the refund as security by failing to timely object to its treatment under the debtor's plan.
>
> In many respects, *Norton* is distinguishable from *Davidovich* and *Carolco* [*De Laurentiis*], and the different principles on which these very different decisions rely are not necessarily opposed.

5 Collier on Bankruptcy ¶ 553.08[2] (15th ed. 1997). Indeed, the only practical result of any difference in reasoning between the cases is that creditors secured by a right of setoff must read the proposed plan of reorganization. Given that the Third Circuit below merely follows its prior opinion in *Norton*, the situation has not changed

since this Court denied certiorari in *De Laurentiis*. No conflict between the circuits exists.

B. THE COURT BELOW CORRECTLY CONSTRUED *STRUMPF*

Petitioner also argues that the decision below cannot be reconciled with *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995). *Strumpf*'s holding, however, is unrelated to whether an unasserted right of setoff survives plan confirmation. Instead, *Strumpf* addressed solely whether a bank's temporary freeze on the debtor's bank account in order to preserve a right of setoff violated the automatic stay under 11 U.S.C. § 362(a). The Court found that the property at issue was a promise to pay and that the temporary refusal to honor that promise was neither a setoff nor an exercise of control over the debtor's property within § 362(a). *Id.* at 21.

Petitioner misconstrues *Strumpf* to stand for the proposition that a promise to pay subject to setoff is not "property of the estate" and compounds its error by proposing that an obligation subject to setoff therefore cannot vest in the debtor "free and clear" upon plan confirmation under § 1141(c). Petitioner ignores the fact that Continental owns the funds in the Court's registry; GSA's obligation was not a "promise to pay." *See In re Ionosphere Clubs, Inc.*, 164 B.R. 839 (Bankr. S.D.N.Y. 1994) (denying Petitioner's attempt to set off against *Alaska Airlines* funds due to Eastern Airlines.) Thus, the facts do not fit within Petitioner's misinterpretation of *Strumpf*.

Strumpf did not even suggest that the debtor's right to payment was not "property of the estate." Rather, the

Court observed only that the bank's temporary refusal to pay did not violate the automatic stay. The Court could not determine what Congress defined as property of the estate without reference to the Bankruptcy Code's definition of "property of the estate" in 11 U.S.C. § 541. The Court neither cites nor references § 541 in *Strumpf*. *See In re USA Diversified Products, Inc.*, 196 B.R. 801, 806 (N.D. Ind. 1996) (*Strumpf* did not purport to change what constitutes property of the estate), *aff'd*, 100 F.3d 53 (7th Cir. 1996); *see also In re Bakersfield Westar Ambulance, Inc.*, 123 F.3d 1243, 1246 (9th Cir. 1997) (bank account is intangible property right of debtor).

Further, *Strumpf* did not address how plan confirmation might affect the right to setoff. 516 U.S. at 21, n.2. The Third Circuit therefore properly rejected the Government's contention that *Strumpf* was applicable.

C. INDEPENDENT GROUNDS SUPPORT THE DECISION BELOW

1. Petitioner Cannot Set Off Against Funds Which Continental Owns.

Petitioner's question presented – whether the Plan extinguished its setoff rights – wrongly assumes that Petitioner owed a debt against which it could set off. The only courts to reach the issue found no debt and thus no setoff right. The Third Circuit did not reach the issue, finding that petitioner's setoff rights, "if any," were extinguished by the Plan. (*See* App. at 14a.)

Alaska Airlines "declared that because GSA holds funds withheld illegally, funds rightfully belonging to the airlines . . . the government had no right to the withheld

money [and] that money had to be returned." *Alaska Airlines, Inc. v. Johnson*, 8 F.3d 791, 797 (Fed. Cir. 1993). Petitioner therefore cannot establish the mutuality of debts required for setoff. The Magistrate-Judge, in her report and recommendation on appeal, concurred: "[T]he *Alaska Airlines* Fund is 'clearly **owned by**, as opposed to **owed to** the Debtor,' and thus the Government has no right to utilize this Fund to offset its debts." (App. at 43a) (*emphasis in original*) (*quoting Ionosphere Clubs*, 164 B.R. at 841.)

2. Continental's Plan Specifically Prohibits Setoff without Continental's Consent.

Continental's Plan expressly reserved the right to setoff against claims solely to *Continental*, stating:

> 14.8 *Setoffs*. Each Debtor and NewCal and the NewCal Subs may, *but shall not be required to*, set off or recoup against any Claim and the payments or other distributions to be made pursuant to the Joint Plan in respect of such Claim, claims of any nature whatsoever which such Debtor or NewCal or the NewCal Subs may have against the holder of such Claim.

(emphasis added.) (*See* Resp. App. at 20a.) Continental elected not to set off its claims here.

A creditor with notice of a proposed plan's effect on lien rights, who fails to object, is bound by the resulting alteration of its rights. *See In re Corbett*, 124 F.3d 82, 87 (2d Cir. 1997); *In re Barton Industries, Inc.*, 104 F.3d 1241, 1245 (10th Cir. 1997) (recognizing rule but finding notice in that case to be insufficient); *Trulis v. Barton*, 107 F.3d 685,

691 (9th Cir. 1995); *In re Penrod*, 50 F.3d 459 (7th Cir. 1995); *Wallis v. Justice Oaks II*, 898 F.2d 1544, 1550 (11th Cir. 1990), *cert. denied*, 498 U.S. 959 (1990); *United States Dept. of Air Force v. Carolina Parachute Corp.*, 907 F.2d 1469, 1473 (4th Cir. 1990); *In re Szostek*, 886 F.2d 1405 (3rd Cir. 1989) (applying rule in Chapter 13). A confirmed plan binds any creditor to its provisions even if the result would not otherwise be obtainable under applicable law had the creditor objected. *See Stoll v. Gottlieb*, 305 U.S. 165 (1938); *Jones v. Keene Corp.*, 933 F.2d 209 (3rd Cir. 1991); *Republic Supply Co. v. Shoaf*, 815 F.2d 1046 (5th Cir. 1987). The reason for the broad scope of § 1141(a) (and its counterpart, § 1327) is the need for finality and certainty. *In re Szostek*, 886 F.2d at 1406; *In re Norton*, 717 F.2d at 774; *In re Brenner*, 189 B.R. 121, 126 (Bankr. N.D. Ohio 1995).

Creditors are obliged to actively protect their claims. *See In re Penrod*, 50 F.3d at 463; *In re Szostek*, 886 F.2d at 1414; *Heins v. Ruti-Sweetwater, Inc. (In re Ruti-Sweetwater, Inc.)*, 836 F.2d 1263 (10th Cir. 1988). The minimal level of diligence required by the ruling below is no greater a burden than other provisions of the Bankruptcy Code impose on creditors in the interests of finality. *See, e.g., Taylor v. Freeland & Kronz*, 503 U.S. 638, 642 (1992) (barring a tardy challenge to an improper claim of exemption). Here, the United States made only one objection related to the right of setoff and then agreed to limit that right.

An order of confirmation is a final judgment. *In re Lykes Bros. Steamship Co.*, 217 B.R. 304, 310 (Bankr. M.O. Fla. 1997) (citing *Stoll v. Gottlieb*, 305 U.S. 165, *reh'g denied*, 305 U.S. 675 (1938)). The Bankruptcy Court's jurisdiction,

Petitioner's full and fair opportunity to raise objections, Petitioner's participation in the confirmation proceedings, and the finality of the order confirming Continental's Plan are undisputed. Section 1141(a) and the doctrine of *res judicata* now preclude Petitioner's assertion of setoff rights in contravention of both the Plan and the order confirming it. *Lykes Bros.*, 217 B.R. at 310.

The Third Circuit did not comment on the effect of the Plan language, but the District Court found it also dispositive. (*See* App. at 28a-29a.) Petitioner attempts to sidestep this independent ground for affirmance by claiming that the Plan "did not provide for or mention the setoff rights of creditors," but only Continental's setoff rights. The equitable doctrine of setoff is, however, a mutual right. *Strumpf*, 516 U.S. at 17. Petitioner, therefore, draws a distinction without a difference; one party cannot set off without requiring the same of the other party. Here, Continental's Plan controls the mutual right. No matter how the right is characterized, petitioner cannot require Continental to set off in contravention of § 14.8 of the confirmed Plan.

In bankruptcy, setoff is discretionary. *U.S. v. Norton*, 717 F.2d at 772; *In re Penn Cen. Trans. Co.*, 486 F.2d 519, 529 (3rd Cir. 1973) (*en banc*), *cert. denied sub nom., Chicago and North Western Transp. Co. v. Baker*, 415 U.S. 990 (1974), *and cert. denied sub nom., Baker v. Indiana Harbor Belt R.R. Co.*, 415 U.S. 990 (1974). Continental's Plan left setoff to Continental's discretion. As the District Court stated, the Plan "expressly prohibits the United States from setting off its claims without Continental's approval," a result reached

independent of § 1141(c). (*See* App. at 29a-30a.) Where, as here, the court's findings of fact are not clearly erroneous, its decision will not be upset on appeal absent an abuse of discretion. *Meridian Bank v. Allen*, 958 F.2d 1226, 1230, n.2 (3rd Cir. 1992); *In re Vertientes, Ltd.*, 845 F.2d 57, 59 (3rd Cir. 1988).

3. The United States Waived Its Right of Setoff.

In distinguishing *De Laurentiis*, the Third Circuit noted the United States filed proofs of claim, but failed to assert any right to setoff. (*See* App. 2a, 12a.) The right to setoff is waived if not asserted when the creditor elects to participate in the bankruptcy case by filing a claim. *In re Calore Express Co.*, 199 B.R. 424 (Bankr. D. Mass. 1996); *In re Apex Int'l Management Serv., Inc.*, 155 B.R. 591, 595 (Bankr. M.D. Fla. 1993), *aff'd*, 1996 WL 172210 (M.D. Fla. 1996); *In re Britton*, 83 B.R. 914, 919-20 (Bankr. E.D.N.C. 1988); *In re Butler*, 61 B.R. 790 (Bankr. S.D. Fla. 1986). *See also In re Metropolitan International, Inc.*, 616 F.2d 83, 95 (3rd Cir. 1980) (the right of setoff is a privilege which must be asserted or it will be considered waived and lost); *In re Mauch Chunk Brewing Co.*, 131 F.2d 48 (3rd Cir. 1942). *Compare with In re Wells*, 125 B.R. 297 (Bankr. D. Colo. 1989).

The District Court and the Third Circuit did not find it necessary to reach this point, but both the Bankruptcy Court and the Magistrate Judge found that the government's proofs of claim, along with other facts, demonstrated a waiver. (*See* App. at 50a-51a, 54a-55a.) Here, the United States agreed to restrict its setoff rights to IRS claims. Only the FAA asserted any material setoff right in

a proof of claim, but then agreed to treatment of its claim "as a general unsecured claim" not reduced by any setoff right. (*See* Resp. App. at 15a.) In return, Continental and its creditors relinquished the right to subordinate the FAA's pre-petition penalty claims. (*See* Plan §§ 1.43, 1.139 and 1.169, Resp. App. at 18a-19a.) Section 14.14(b) of Continental's Plan thus specifically treated the FAA as a "general unsecured creditor with an Allowed General Unsecured Claim." (*See* Resp. App. at 21a.) Similarly, the United States requested and received special treatment in the Plan for the DOT's claim without reduction for any setoff. Under Section 14.14(a) of the Plan, its general unsecured claim was paid in full as a priority administrative expense. (*See* Resp. App. at 20a.)

The United States accepted the advantage of better treatment for its claims to the detriment of creditors while keeping them unaware of its intent to claim the advantage of setoff for its general unsecured claims. The right to setoff may be lost if the creditor's conduct is inconsistent with a subsequent claim to such right. *See Cumberland Glass Mfg. Co. v. DeWitt and Co.*, 237 U.S. 447, 459 (1915); *In re Public Service Co. of New Hampshire*, 884 F.2d 11 (1st Cir. 1989). By negotiating for inconsistent treatment, the United States waived any right to setoff. *In re Holly's, Inc.*, 190 B.R. 297, 301 (Bankr. W.D. Mich. 1995). Further, the United States allowed Continental to spend years attempting to recover the illegally withheld funds without ever counterclaiming or amending its proofs of claim, but instead remaining silent for long after the

Comptroller General's decisions and even after the District Court entered an injunction requiring return of Continental's money. *See In re Apex Int'l Management Serv., Inc.*, 155 B.R. at 595-96 (silence supports waiver).

Section 553 does not prohibit a creditor from waiving the right of setoff. *See In re Holder*, 182 B.R. 770 (Bankr. M.D. Tenn. 1995); *In re Custom Center, Inc.*, 163 B.R. 309, 317 (Bankr. E.D. Tenn. 1994) (recognizing application of waiver against IRS, but finding no waiver on the facts); *In re Gehrke*, 158 B.R. 465, 468-9 (Bankr. N.D. Iowa 1993). The finding of a waiver was not an abuse of discretion and should be affirmed. *In re Cascade Roads, Inc.*, 34 F.3d 756, 769 (9th Cir. 1994).

4. The Obligations Here Lack the Mutuality Required for Setoff.

Section 553 of the Bankruptcy Code specifically limits setoff to a "creditor's mutual" debts. To be "mutual," the debts must be owed by the same creditor entity as the entity holding the claim. The Bankruptcy Code defines "governmental units" as separate departments, agencies and instrumentalities of the United States and therefore as separate "creditors." *See* 11 U.S.C. §§ 101(27), (15), (10) (defining "governmental unit," "entity," and "creditor," respectively.) In this case, the United States attempts to setoff GSA's obligation to return $4.6 million in funds illegally withheld against the allowed bankruptcy claims of nine other federal agencies. As the Bankruptcy Court held, the debts lack the mutuality required by 11 U.S.C. § 553(a). (App. 53a-54a.) *See In re Lakeside Community*

Hosp., Inc., 151 B.R. 887 (N.D. Ill. 1993); *In re Hancock*, 137 B.R. 835 (Bankr. N.D. Okla. 1992).

This case illustrates why various governmental units cannot be one creditor. The GSA's refusal to recognize the Comptroller General's authority mandated injunctive relief. *Alaska Airlines*, 801 F. Supp. at 770. Ten different governmental agencies filed separate proofs of claims. Three filed separate objections to confirmation of Continental's Plan on different grounds. All three and the DOT separately negotiated for disparate treatment on the basis of their differing interests, priorities and powers. The facts demonstrate the absence of any basis on which to maintain the fiction of different agencies as a unitary creditor.

Most decisions supporting a right to interagency setoff rely on *Cherry Cotton Mills, Inc. v. United States*, 327 U.S. 536 (1946). *See, e.g., In re HAL, Inc.*, 122 F.3d 851 (9th Cir. 1997); *Turner v. Small Business Administration*, 84 F.3d 1294 (10th Cir. 1996) (*en banc*). *Cherry Cotton*, a non-bankruptcy case decided long before the current Bankruptcy Code, does not address the reality that various federal entities have independent contracting authority, are represented by separate counsel in bankruptcy proceedings, rarely act in concert, assert different priorities, and are subject to varying legal requirements respecting when and under what circumstances they may exercise setoff. *See generally* 31 U.S.C. § 3716 (administrative offset); *Cf. In re Britton*, 83 B.R. 914 (Bankr. E.D.N.C. 1988). Moreover, *Cherry Cotton* does not address the Bankruptcy Code's strict requirements of mutuality under § 553 or the policies that underlie the comprehensive changes it

made to bankruptcy law and practice, including the specific inclusion of departments, agencies, and instrumentalities of the United States as "governmental units" under § 101(27). Therefore, *Cherry Cotton* is not controlling.

Neither the District Court nor the Third Circuit reached the mutuality issue, although the Magistrate Judge recommended affirmance on this alternative basis. (*See* App. at 44a-48a.) Final disposition of this case cannot occur without consideration of this ground.

D. THE THIRD CIRCUIT CORRECTLY DECIDED THE CASE

Upon confirmation of its Plan, Continental's funds, deposited with the Bankruptcy Court by the United States pursuant to the injunction of the District Court, vested in Continental "free and clear of all claims and interests," except as provided in the Plan. *See* 11 U.S.C. § 1141(c). Section 101(5) of the Code defines "claim" as, *inter alia*, a "right to payment . . . secured or unsecured." Section 506(a) of the Code defines a secured claim as "[a]n allowed claim of a creditor secured by a lien on property in which the estate has an interest, *or that is subject to setoff under section 553 of this title.*" (Emphasis added.) To the extent the United States had a right to setoff, it was the holder of a secured claim. Secured claims are precisely the kind of claims encompassed within the phrase "all claims or interests" of § 1141(c). *See In re Penrod*, 50 F.3d at 463.

Further, Continental's Plan specifically vested all property of the estate in the reorganized debtor, free and

clear of any "Claims." (*See* Resp. App. at 25a.) The Plan defined "Claim" as "any right to payment . . . secured or unsecured." (*See* Resp. App. at 18a.) Thus, the Plan vested Continental's claim against the GSA in reorganized Continental free and clear of any right to payment in favor of the United States.

If the property at issue is dealt with under a plan, interests therein which are not specifically provided for will be extinguished. *See In re Penrod*, 50 F.3d at 462; *In re Be-Mac Transport Company, Inc.*, 83 F.3d 1020, 1025 (8th Cir. 1996); *In re Village Craftsmen, Inc.*, 160 B.R. 740 (Bankr. D.N.J. 1993). Although Petitioner contends that debtors will therefore "have every incentive to omit any reference to setoff rights in the Plan," this Court rejected a similar argument in *Taylor v. Freeland & Kronz*, 503 U.S. at 643-644. The United States was required to, but did not, object to Continental's Plan in order to preserve alleged setoff rights besides those to which Continental consented. *In re Village Craftsman*, 160 B.R. at 748. Any rights of setoff Petitioner had were extinguished.

Had Congress intended to insulate claims subject to setoff from those provisions of the Code that affect secured claims, they would be excluded from the definition of secured claims in § 506. To accord § 553 such sweeping preemption would violate a cardinal rule of statutory construction by rendering the inclusion of claims subject to setoff in § 506(a) mere surplusage. *Bailey v. United States*, 516 U.S. 137, 145 (1995). *De Laurentiis*, upon which Petitioner relies, did not consider this potential statutory conflict at all.

Instead, § 553's "does not affect" language has a more reasonable construction. Section 553 does not itself create any right of setoff; the section merely recognizes and preserves setoff rights that exist under other applicable law. *See Strumpf*, 516 U.S. at 17; *see In re Bevil, Bresler & Shulman Asset Management Corp.*; 896 F.2d 54, 57 (3rd Cir. 1990). Section 553's "does not affect" language effectuates the purpose of recognition and preservation, but not creation, of setoff rights.

A proper construction of § 553 easily reconciles any purported conflict with § 506: Section 553 means that the right of setoff is preserved under the Bankruptcy Code, *but claims subject to a right of setoff will be treated as secured claims*. Only then is the language of both statutes given effect. Thus, claims secured by a right of setoff are subject to those provisions of the Code that apply to secured claims generally, such as the rights to and restrictions on collection of interest, fees and costs in § 506(b) or the effects of cramdown pursuant to 11 U.S.C. § 1129(b). *See* 7 Collier on Bankruptcy ¶ 1129.05[2] (15th ed. 1997). If the Plan's treatment of its alleged secured claim was unacceptable, Petitioner needed to object just like any other holder of a secured claim.

III. CONCLUSION

For the foregoing reasons, the Petition for Writ of Certiorari should be denied.

Respectfully submitted,

FAEGRE & BENSON, LLP

CHRISTIAN C. ONSAGER
Counsel of Record
GORDON B. CONN JR.
MICHAEL J. PANKOW
2500 Republic Plaza
370 Seventeenth St.
Denver, CO 80202
(303) 592-9000

Attorneys for Respondent
Continental Airlines, Inc.

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	)	Case Nos. 90 932
CONTINENTAL AIRLINES, INC., et al.,	)	through 90 984
Debtors.	)	

STIPULATED WITHDRAWAL OF UNITED STATES INTERNAL REVENUE SERVICE'S OBJECTION TO DEBTORS' SECOND AMENDED PLAN OF REORGANIZATION

Continental Airlines, Inc., et al., Debtors and Debtors-in-Possession, ("Continental"), and the United States Internal Revenue Service (the "IRS"), through their respective undersigned counsel, hereby stipulate to withdrawal of the IRS's Objection to Debtors' Second Amended Plan of Reorganization (the "Objection"), as follows:

1. The IRS filed its Objection to confirmation of Continental's Revised Second Amended Joint Plan of Reorganization (the "Plan"), objecting to the Plan's proposed treatment of Priority Tax Claims and tax claims which are secured by virtue of a right of setoff under §§ 553 and 506 of the Bankruptcy Code.

2. Capitalized terms used herein shall have the same meaning as in the Plan.

3. Continental will satisfy the Allowed Priority Tax Claims of the IRS by making equal annual installments of principal and interest, which interest shall be calculated pursuant to the rate in effect from time to time under 28

U.S.C. § 6621(a)(2) commencing on the Effective Date, with the first such installment due one year from the Effective Date of the Plan, which installments shall be calculated by amortizing the amount of each tax comprising the Allowed Priority Tax Claim over a six year period that is calculated from the earlier of the date of assessment of each respective tax or the Effective Date of the Plan. Any Allowed Priority Tax Claim for a tax which was assessed more than six years prior to the Effective Date shall be paid in full, in cash upon the 76th day after the Effective Date or, in the event of a timely objection to a tax claim, 30 days after the date such tax claim is Allowed by the Court.

4. Continental waives any rights it might have under Section 4.1 of the Plan to require that any payment made to the IRS prior to or after the Effective Date with respect to any Allowed Priority Tax Claim shall be applied first against any Allowed Trust Fund Tax Claim owing to the IRS.

5. Delivery to the IRS of the Priority Tax Notes shall not, by itself, be deemed to satisfy the Allowed Priority Tax Claims of the IRS, or Continental's obligations under § 1129(a)(9)(C), but are simply to set forth the agreed payment schedule for the Allowed Priority Tax Claims.

6. Notwithstanding any provision in the Plan, the IRS shall not be precluded from asserting any claims and causes of action for its Priority Tax Claims against any present or former officer or director of Continental, including the right to assess any such claim, except that the IRS hereby waives its ability to collect any such

assessment or claim which it may have against any present or former officers or directors of Continental during any and all time periods in which Continental is in compliance with this Stipulation. Nothing in this paragraph or this Stipulation shall be deemed to be a waiver by the present or former directors or officers or [sic] Continental of any rights or defenses they may have under applicable law to any such claims which may be asserted by the IRS, or any admission that such claims exist.

7. All tax claims of the IRS secured under § 506 by virtue of the right to setoff a mutual debt owed to the debtor shall be paid by allowing the IRS to exercise the right to setoff such debt under § 553. The IRS shall be allowed to exercise its right of setoff on the 76th day after the Effective Date or, in the event of a timely objection to such a Secured Tax Claim, 30 days after the date such Tax Claim is allowed by the Court.

8. This Stipulation does not resolve the amounts in which any Priority Tax Claims or Secured Claims of the IRS may be Allowed or the priority of any tax claimed, but resolves only the manner in which such Priority Tax Claims and Secured Claims, when and if Allowed as provided in the Plan, will be paid by Continental under the Plan.

9. If required by the Bankruptcy Court or if otherwise deemed advisable by Continental, Continental will amend the Plan to comport with this Stipulation. If Continental does not amend the Plan to comport with paragraphs 4 and 6 hereof, such provisions shall be recited in the order entered by the Bankruptcy Court confirming the Plan.

10. This Stipulation shall constitute the full agreement between the parties hereto regarding payment of the Allowed Priority Tax Claims and Secured Claims owed to the IRS, except as such claims are addressed in prior stipulations and agreements between the parties, and nothing herein shall serve to prejudice or prevent Continental from agreeing to any different terms or arrangements with any other taxing authorities, as part of a stipulation or otherwise, if Continental, in its sole discretion, deems it in its best interest to agree to such terms. Moreover, nothing in this Stipulation shall be deemed to be a waiver by Continental of any rights it may have under the Plan as to any other person or entity, nor may any of the terms in this Stipulation be used by any other party to construe the Plan.

11. The Stipulation resolves all objections asserted by the IRS to confirmation of the Plan, and the IRS's objection will be deemed withdrawn upon Court approval hereof.

Respectfully submitted this 16th day of March, 1993.

YOUNG, CONAWAY, STARGATT
& TAYLOR
James L. Patton, Jr.
Laura Davis Jones
11 Rodney Square North
P.O. Box 391
Wilmington, Delaware 19899
(302) 571-6684

FAEGRE & BENSON

/s/ Christian C. Onsager
Christian C. Onsager
Adrienne O'Connell McNamara
2500 Republic Plaza
370 Seventeenth Street
Denver, Colorado 80202-4004
(303) 592-5900

ATTORNEYS FOR
CONTINENTAL AIRLINES
INC., et al.

/s/ William C. Carpenter, Jr.
William C. Carpenter, Jr.
United States Attorney
Ellen Slights
Assistant United States
Attorney
Michael J. Kearns
David B. Blair
Trial Attorneys, Tax Division
U.S. Department of Justice
555 Fourth Street, N.W.
Room 6808
Washington, D.C. 2001

ATTORNEYS FOR THE
UNITED STATES INTERNAL
REVENUE SERVICE

CERTIFICATE OF SERVICE

I, Robert S. Brady, Esquire, hereby certify that I caused the foregoing document to be served in the manner indicated upon the following:

VIA FEDERAL EXPRESS

The Hon. Thomas E. Ross
Office of the United States Trustee
601 Walnut Street
Suite 950 West, Curtis Center
Philadelphia, PA 19106

Bennett J. Murphy, Esquire
Latham and Watkins
53rd at Third
885 third [sic] Avenue
New York, New York 10022

Benjamin Waisbren, Esquire
Lord, Bissell and Brook
115 S. LaSalle Street
Chicago, Illinois 60603

William C. Carpenter, Jr.
Michael J. Kearns
David B. Blair
Trial Attorneys, Tax Division
Internal Revenue Service
U.S. Department of Justice
555 Fourth Street, N.W., Room 6808
Washington, DC 20001

VIA HAND DELIVERY

Ellen Slights
Assistant United States Attorney
U.S. Attorney's Office
1201 Market Street, Suite 1100
Wilmington, DE 19899-2046

Dated at Wilmington, Delaware this 17th day of March 1993.

/s/ Robert S. Brady
ROBERT S. BRADY

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	:	Case Nos. 90-932 through 90-984
CONTINENTAL AIRLINES, INC., *et al.*,	:	Jointly Administered Under Case No. 90-932
Debtors.	:	

STIPULATION BY AND BETWEEN THE UNITED STATES OF AMERICA AND THE DEBTORS AS TO RESOLUTION AND WITHDRAWAL OF CERTAIN OBJECTIONS TO DEBTORS' REVISED SECOND AMENDED JOINT PLAN OF REORGANIZATION, AS MODIFIED

This stipulation, which is subject to Bankruptcy Court approval, is being made by and between The United States of America (the "U.S. Government") and Continental Airlines, Inc., *et al.* debtors and debtors-in-possession ("Continental" or "Debtors"), acting by and through their respective undersigned counsel, as follows:

1. The United States Department of Justice, on behalf of the Department of Agriculture ("USDA") and the Federal Aviation Administration ("FAA"), filed timely objections to confirmation of Continental's Revised Second Amended Joint Plan of Reorganization (the "Plan").

2. Continental and the U.S. Government have subsequently negotiated concerning such objections and have reached the agreement set forth herein to settle such objections.

3. The Debtors will file a further Modification to the Plan prior to the conclusion of the confirmation hearing on the Plan. Such modification will add the following language at the end of Section 12.4(a) of the Plan:

> "; and *provided, further, however,* that the provisions of this Section 12.4(a) shall not apply to claims or causes of action by the United States or any agency thereof."

4. This Stipulation resolves: a) the objections of the USDA to confirmation of the Plan and b) that portion of the FAA's objections pertaining to the provisions set forth in Section 12.4(a) of the Plan. Upon entry of the order approving this Stipulation, the USDA's objections and the relevant portion of the FAA's objections will be deemed withdrawn with prejudice.

Dated: Wilmington, Delaware
April 7, 1993

YOUNG, CONAWAY, STARGATT
& TAYLOR

/s/ Laura Davis Jones
Laura Davis Jones
11th Floor
Rodney Square North
P.O. Box 391
Wilmington, DE 19889-0391
(302) 571-6600

Attorneys for Debtors and
Debtors-in-Possession

WILLIAM C. CARPENTER, JR.
UNITED STATES ATTORNEY

/s/ Ellen W. Slights
Ellen W. Slights
Assistant United States
Attorney
Chemical Bank Building
1201 Market Street
Suite 1100
P.O. Box 2046
Wilmington, DE 19889-2046

SO ORDERED:

_____

UNITED STATES BANKRUPTCY
JUDGE

THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In Re:

CONTINENTAL AIRLINES, INC. et al.,

Chapter 90-932
Case No. 90-984

Debtors.

SETTLEMENT AGREEMENT BETWEEN
THE FEDERAL AVIATION ADMINISTRATION
AND
CONTINENTAL AIRLINES, ET AL.

This Agreement is entered into on November 26, 1991, between the Federal Aviation Administration (hereinafter "the FAA") and Continental Airlines, Inc., and its affiliated companies: Peoples Express Airlines, Inc., New York Air, Inc., Frontier Airlines, Inc., Britt Airways, Inc., Rocky Mountain Airways, Inc., and Bar Harbor Airlines, Inc., doing business as Continental Express, their successors in interest or assignees (hereinafter collectively referred to as "the Company").

Recitals

A. The Company holds Air Carrier Operating Certificates and operations specifications issued thereunder by the FAA authorizing it to engage in operations in air transportation under Parts 121 and 135 of the Federal Aviation Regulations (14 C.F.R. Part 1, *et seq.*; hereinafter "the FAR").

B. The Company is subject to civil penalty not to exceed $10,000 for each violation of the Federal Aviation Act of 1958, as amended, (hereinafter "the Act"), (49 U.S.C. App. 1471), the Hazardous Materials Transportation Act (49 U.S.C. App. 1809), (hereinafter "the HMTA"), the FAR, and the Department of Transportation Hazardous Materials Regulations (hereinafter "the HMR"), including requirements involving maintenance, operations, and security in air transportation as specified in Parts 91, 108, 121, and 135 of the FAR and the transportation of hazardous materials by air as specified in the HMR.

C. On December 3, 1990 (the "petition date"), the Company filed a petition in the United States Bankruptcy Court for the District of Delaware to effect a reorganization pursuant to Chapter 11 of Title 11 of the United States Code.

D. The FAA has notified the Company of violations by the Company of the Act and/or the FAR alleged to have occurred prior to the Petition Date, which alleged violations are more particularly described in civil penalty letters, notices of proposed civil penalty, letters of investigation, and other documents.

E. The FAA and the Company mutually desire to resolve all outstanding disputes between them concerning the foregoing matters.

F. The Company offered, pursuant to section 901(a)(2) of the Act (4 U.S.C. App. 1471(a)(2)), three million, four hundred five thousand, seven hundred dollars ($3,405,700) to effect a compromise settlement of all civil

penalties for alleged prepetition date violations of maintenance, operations, security, and hazardous materials regulations.

NOW THEREFORE IT IS MUTUALLY AGREED BY AND BETWEEN THE FAA AND THE COMPANY THAT:

1. The FAA accepts the Company's compromise offer in full settlement of any civil penalties the Company may have incurred under the Act or any regulations issued thereunder or under the HMTA or any regulations issued thereunder for the alleged violations described above. This settlement is applicable to any and all such violations which occurred at any time prior to the Petition Date without regard to whether or not the FAA has notified the Company of any such alleged violation.

2. The compromise amount provided for in this Settlement Agreement shall be deemed a general, unsecured claim in favor of the FAA and, as such, is undisputed and allowed in the amount of $3,405,700.

3. The FAA will take no other action to recover civil penalties from the Company for violations of the Act, the HMTA, the FAR, or the HMR occurring before the Petition Date, and the FAA will not take certificate action under Section 609 of the Act (49 U.S.C. App. 1429) for any maintenance, operations, or security violations that occurred before the Petition Date; provided, however, that nothing herein shall preclude the FAA from taking such alleged violations into consideration when addressing violations which occur after the Petition Date and which in the FAA's view warrant remedial certificate action.

4. It is understood and agreed that the offer by the Company and its acceptance by the FAA do not constitute an admission by the Company with respect to said alleged violations. The offer does not constitute acceptance or agreement by the Company with the procedural regulations set out in 14 C.F.R. Part 13.

5. As to cases for violations occurring before the Petition Date which have been initiated under the civil penalty assessment authority of the FAA (14 C.F.R. Section 13.16), this Agreement shall constitute a Compromise Order under 14 C.F.R. Section 13.16(1)(1).

6. Promptly after execution of this Settlement Agreement and after approval thereof by the Bankruptcy Court on or before November 26, 1991, the FAA will file in the Bankruptcy Court a Proof of Claim in the amount of $3,405,700. Both parties will seek to obtain the approval of this Settlement Agreement by the Bankruptcy Court. In the event said approval is not obtained, this Settlement Agreement shall be null and void and of no effect whatsoever. If the Bankruptcy Court does not approve this Settlement Agreement on or before November 26, 1991, the parties agree that the FAA thereafter may file in the Bankruptcy Court a Proof of Claim in the form, in the manner, and in the amount, that it deems appropriate.

7. This Agreement shall be binding upon and shall inure to the benefit of the parties and their respective successors and assignees. This Agreement shall not be amended, modified, waived or supplemented in whole or in part except in writing and with the written consent of the parties hereto.

8. With respect to payment of the compromise settlement amount of $3,405,700, the FAA recognizes and acknowledges that it is a general, unsecured creditor of the Company. The Company agrees that its Plan of Reorganization or other Plan filed in connection with Case No. 90-932 through 90-984 (U.S. Bankruptcy Court for the District of Delaware) shall provide that the FAA is a general, unsecured creditor with an allowed and undisputed general, unsecured claim totalling $3,405,700. Under the Plan, the treatment of the FAA's allowed claim shall be equal to the best treatment afforded any other general unsecured creditor's allowed claim. The FAA expressly reserves its right to object to any Plan of Reorganization or other Plan submitted by the Company in the event that the Plan does not fully comply with the terms of this Agreement. Payment shall be made to the FAA at the Office of the Chief Counsel.

9. This Agreement and the terms and conditions hereof shall survive the execution and delivery of the Agreement and entry of an order of the Court approving the Agreement, confirming a Plan of Reorganization or other Plan, appointing a trustee or examiner for the Company and/or converting the case from a Chapter 11 case to a Chapter 7 case.

IN WITNESS WHEREOF, the FAA and the Company acting by and through their duly authorized representatives have duly executed this Settlement Agreement as of the day and year first above written.

/s/ J. David Grizzle
J. David Grizzle
Assistant Secretary
For the Company

/s/ John H. Cassady
John H. Cassady
Deputy Chief Counsel
For the Federal Aviation Administration

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	§	Case Nos.
	§	90-932 through 90-984
CONTINENTAL AIRLINES, INC.,	§	
et al.,	§	Jointly Administered
	§	Under Case No. 90-932
Debtors.	§	

DEBTORS' REVISED SECOND AMENDED JOINT PLAN OF REORGANIZATION UNDER CHAPTER 11 OF THE UNITED STATES BANKRUPTCY CODE

CONTINENTAL AIRLINES, INC.
Robert M. Rowen, Esq.
Joni D. King, Esq.
2929 Allen Parkway
Houston, Texas 77019

HUGHES HUBBARD & REED
One Battery Park Plaza
New York, New York 10004
(212) 837-6000

Of Counsel:
John K. Hoyns
David M. LeMay
Co-Counsel to the Debtors and Debtors-In-Possession

YOUNG, CONAWAY, STARGATT & TAYLOR
11th Floor, Rodney Square North
Wilmington, Delaware 19801
(302) 571-6642

Of Counsel:
Laura Davis Jones
Co-Counsel to the Debtors and Debtors-In-Possession

FULBRIGHT & JAWORSKI
1301 McKinney Street
Suite 5100
Chevron Tower
Houston, Texas 77010
(713) 651-5151

Of Counsel:
Zack A. Clement
Co-Counsel to the Debtors and Debtors-in-Possession

Dated: Houston, Texas
January 13, 1993

* * *

ARTICLE 1.

DEFINITIONS

As used in this Joint Plan, the following terms shall have the respective meanings specified below:

* * *

1.43. Claim: Any right to payment from any of the Debtors, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured arising at any time before the Effective Date or relating to any event that occurred before the Effective Date; or any right to an equitable remedy for breach of performance if such breach gives rise to a right of payment from any of the Debtors, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured.

* * *

1.139. Penalty Claim: Any Claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the Petition Date, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary losses suffered by the holder of such claim.

* * *

1.169. Subordinated Claim: Any Penalty Claim and any Unsecured Claim which (i) by its terms or by agreement is subordinated to the payment of any other

Unsecured Claim, (ii) is subordinated to the payment of another Claim pursuant to any applicable provision of the Bankruptcy Code (including, without limitation, sections 510(b) and 509(c) thereof) or applicable non-bankruptcy law, (iii) is equitably subordinated to the payment of another Claim by a Final Order of the Bankruptcy Court entered pursuant to section 510(c) of the Bankruptcy Code. Subordinated Claims include, but are not necessarily limited to, all CAL 11% Subordinated Debenture Claims, all CAL 3.5% Convertible Subordinated Debenture Claims, the Rubicon Note Claims, all CTA 6% Convertible Subordinated Note Claims, all CTA 10% Exchangeable Subordinated Debenture Claims and all CTA Subordinated Guarantee Claims.

* * *

ARTICLE 12.

MEANS FOR IMPLEMENTATION OF THE JOINT PLAN

* * *

12.11. Revesting of Assets; No Further Supervision. The assets of each Debtor and all property of each Debtor's estate (including without limitation, all rights of the Debtors to recover property under sections 542, 543, 550 and 553 of the Bankruptcy Code, and all avoiding powers under sections 522(f), 522(h), 544, 545, 547, 548, 549 or 724(a) of the Bankruptcy Code and all proceeds thereof) shall revest in NewCal (which shall convey the assets of the Commuter Debtors to NewEx and the assets of the System One Debtors to NewOne), in each case free and clear of all Claims and Equity Interests, including, without limitation, any and all Eastern Claims, but subject to the obligations of NewCal and the NewCal Subs as

specifically set forth in this Joint Plan. The Joint Plan does not contain any restrictions or prohibitions on the conduct of the business of NewCal, NewEx or NewOne. NewCal and the NewCal Subs may use, operate and deal with their respective assets, and may conduct and change their businesses, without any supervision by the Bankruptcy Court or the Office of the United States Trustee, and free of any restrictions imposed on the Debtors by the Bankruptcy Code or by the Bankruptcy Court during the Chapter 11 Case.

* * *

ARTICLE 14.

MISCELLANEOUS PROVISIONS

* * *

14.8. Setoffs. Each Debtor and NewCal and the NewCal Subs may, but shall not be required to, set off or recoup against any Claim and the payments or other distributions to be made pursuant to the Joint Plan in respect of such Claim, claims of any nature whatsoever which such Debtor or NewCal or the NewCal Subs may have against the holder of such Claim to the extent such claim may be set off or recouped under applicable law, but neither the failure to do so nor the allowance of any Claim hereunder shall constitute a waiver or release by such Debtor or NewCal or the NewCal Subs, of any such claim that it may have against such holder.

* * *

14.14. Implementation of DOT and FAA Stipulations.

(a) Pursuant to (i) the DOT's Consent Order No. 91-7-11, dated July 11, 1991, as amended by Order

91-8-42, dated August 20, 1991, and (ii) the Bankruptcy Court's "Order Granting Motion to Approve Settlement and Fixing of Allowed Claim Amount for the U.S. Department of Transportation," dated November 26, 1991, the DOT has (subject to confirmation of this Joint Plan) an Allowed Administrative Claim against CAL in the amount of $30,000, and pursuant to the terms of the foregoing orders, such Allowed Administrative Claim shall be paid in full within one year from the date on which the Confirmation Order becomes a Final Order. Pursuant to the Orders referred to above, such Allowed Administrative Claim is to bear interest at the rate set for interest on General Unsecured Claims under this Joint Plan. Because no interest will be paid upon Allowed General Unsecured Claims pursuant to this Joint Plan, the DOT's Allowed Administrative Claim of $30,000 shall not bear interest.

(b) Pursuant to the "Settlement Agreement Between the Federal Aviation Administration and Continental Airlines, et al.", dated November 26, 1992, and approved by the Bankruptcy Court, the Federal Aviation Administration is a general unsecured creditor with an Allowed General Unsecured Claim against CAL in the amount of $3,405,700. Such Allowed General Unsecured Claim is a Class A General Unsecured Claim pursuant to this Joint Plan and shall be treated under this Joint Plan in the same manner as all other Allowed Class A General Unsecured Claims.

* * *

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	)	Case Nos.
	)	90-932 through 90-984
CONTINENTAL AIRLINES, INC., *et al.*,	)	
	)	
Debtors.	)	

FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER CONFIRMING THE DEBTORS' REVISED SECOND AMENDED JOINT PLAN OF REORGANIZATION, AS MODIFIED, UNDER CHAPTER 11 OF THE UNITED STATES BANKRUPTCY CODE AND GRANTING RELATED RELIEF

Continental Airlines, Inc. ("CAL"), Continental Airlines Holdings, Inc. ("CTA") and the affiliated debtors and debtors-in-possession in these jointly-administered Chapter 11 cases (collectively, the "Debtors"), having filed with the Court the Debtors' Revised Second Amended Joint Plan of Reorganization under Chapter 11 of the United States Bankruptcy Code, dated January 13, 1993, and having modified such Plan by Modifications filed with the Court on March 12, 1993, April 9, 1993, and on April 16, 1993 (as so modified, the "Plan"; capitalized terms used in this Order and not otherwise defined shall have the respective meanings ascribed to such terms in the Plan); and the Debtors' Revised Third Amended Disclosure Statement, dated January 13, 1993 (the "Disclosure Statement"), having been filed with and approved by the Court pursuant to an order dated January 8, 1993 (the "Disclosure Statement Order") as containing "adequate information" pursuant to section 1125 of title 11,

United States Code (the "Bankruptcy Code"); and copies of (a) the Plan, (b) the Disclosure Statement, (c) a letter of the Official Committee of Unsecured Creditors in a form approved by the Court, and (d) the appropriate ballot(s) (for those Creditors entitled to vote on the Plan), having been transmitted to all Creditors entitled to receive the same pursuant to the Disclosure Statement Order, the United States Trustee, Counsel for the Official Committee of Unsecured Creditors and the Official Committee of Equity Security Holders, all indenture trustees and those parties who have filed notices of appearance in the Debtors' Chapter 11 cases pursuant to Bankruptcy Rule 2002, the Securities and Exchange Commission, the District Director of Internal Revenue for the district in which these Chapter 11 cases are pending, and the United States Attorney for the District of Delaware, all in accordance with the Disclosure Statement Order; and the Disclosure Statement Order having fixed (a) on or before 4:00 p.m. Eastern Standard Time, on February 16, 1993 or, if the Disclosure Statement and related solicitation materials were mailed to a Creditor after January 19, 1993, with respect to such Creditor, the 28th day after they are so mailed, as the last date and time by which all Ballots must be properly completed, executed, marked and received by the Debtors at one of the addresses specified for that purpose in the Disclosure Statement and in the Published Notice described in the Disclosure Statement Order, in order to be considered as acceptances or rejections of the Plan; and (b) February 23, 1993 (which date was thereafter continued to March 16, 1993, by order of the Court), at 9:30 a.m., as the time and date for the

hearing pursuant to sections 1128 and 1129 of the Bankruptcy Code (the "Confirmation Hearing") to consider confirmation of the Plan and any objections thereto including, without limitation, any objection to the Disclosure Statement dealing with a confirmation issue (the "Objections"); and due notice of the Confirmation Hearing and the date by which Objections must be filed having been given and published in accordance with the terms of the Disclosure Statement Order; and due notice of the continuance of the Confirmation Hearing to March 16, 1993, having been given; and the Court having ruled at the Disclosure Statement Hearing that consideration of objections to the Disclosure Statement dealing with a confirmation issue would be deferred until the Confirmation Hearing without the need for refiling; and the Confirmation Hearing having been held before the Court beginning on March 16, 1993 and continuing thereafter on March 17, 18, 19, 25, 26 and 30, 1993 and April 7 and 16, 1993; and the appearance of all interested parties having been noted on the record; and the Court having considered all objections to confirmation of the Plan and to this Order; and upon all the record and the evidence adduced at the Confirmation Hearing (including testimony and exhibits admitted into evidence) and upon the Debtors' Memorandum in Support of Confirmation of the Plan, and upon the Affidavits submitted in support of confirmation of the Plan and upon the submissions, including affidavits and offers of proof, at the Confirmation Hearing, the arguments and representations of counsel, and all pleadings and proceedings had herein, the Court makes the following Findings of Fact and Conclusions of Law setting forth the reasons for the Court's issuance of this

Order confirming the Plan, overruling the outstanding Objections, and granting the other relief provided for herein:

THE COURT HEREBY FINDS THAT:

* * *

11. In accordance with section 1141 of the Bankruptcy Code, and except for any security interests provided under the Plan or contemplated by the Financing Transaction, any property transferred or otherwise dealt with in the Plan shall be free and clear of all Claims against and Equity Interests in the Debtors, and all such property of the Debtors' estates shall, on the Effective Date, vest in those entities as designated in and provided for by the Plan. Pending the occurrence of the Effective Date, all such property shall remain property of each respective Debtor's bankruptcy estate, and such bankruptcy estates shall continue until the occurrence of the Effective Date.

* * *

33. On March 16, 1993, the Internal Revenue Service and the Debtors entered into a "Stipulated Withdrawal of United States Internal Revenue Service's Objection to Debtors' Second Amended Plan of Reorganization." Such stipulation is hereby approved pursuant to Bankruptcy Rule 9019(a) as a just, equitable and non-discriminatory compromise of the Internal Revenue Service's Objection to Second Amended Joint Plan of Reorganization, which the IRS filed on March 9, 1993.

* * *

Dated: Wilmington, Delaware
April 16, 1993

/s/ Helen S. Balick
Helen S. Balick
United States
Bankruptcy Judge

§ 101. Definitions

In this title –

* * *

(10) "creditor" means –

(A) entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor;

(B) entity that has a claim against the estate of a kind specified in section 348(d), 502(f), 502(g), 502(h) or 502(i) of this title; or

(C) entity that has a community claim;

* * *

(15) "entity" includes person, estate, trust, governmental unit, and United States trustee;

* * *

(27) "governmental unit" means United States; State; Commonwealth; District; Territory; municipality; foreign state; department, agency, or instrumentality of the United States (but not a United States trustee while serving as a trustee in a case under this title), a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state; or other foreign or domestic government;

* * *

§ 506. Determination of secured status

(a) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is

subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

(b) To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

(c) The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim.

(d) To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless –

(1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or

(2) such claim is not an allowed secured claim due only to the failure of any entity to file

a proof of such claim under section 501 of this title.

Supreme Court, U.S.
FILED
SEP 17 1998

No. 98-130

In the Supreme Court of the United States

OCTOBER TERM, 1997

UNITED STATES OF AMERICA, PETITIONER

v.

CONTINENTAL AIRLINES
THOMAS E. ROSS, TRUSTEE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

SETH P. WAXMAN
Solicitor General
Counsel of Record
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

13 pp

TABLE OF AUTHORITIES

Cases:	Page
Alaska Airlines, Inc. v. *Austin*, 801 F. Supp. 760 (D.D.C. 1992), aff'd in part, rev'd in part, 8 F.3d 791 (Fed. Cir. 1993)	6, 8, 9
Chateaugay Corp., In re, 94 F.3d 772 (2d Cir. 1996)	6, 7
Cherry Cotton Mills, Inc. v. *United States*, 327 U.S. 536 (1946)	9
Citizens Bank of Maryland v. *Strumpf*, 516 U.S. 16 (1995)	3, 7
Davidovich, In re, 901 F.2d 1533 (10th Cir. 1990)	4, 5, 6, 7, 9
De Laurentiis Entertainment Group, Inc., In re, 963 F.2d 1269 (9th Cir.), cert. denied, 506 U.S. 918 (1992)	4, 5, 6, 7
G.S. Omni Corp., In re, 835 F.2d 1317 (10th Cir. 1987)	6
HAL, Inc., In re, 122 F.3d 851 (9th Cir. 1997)	10
Lehigh & Hudson River Ry., In re, 468 F.2d 430 (2d Cir. 1972)	2
Trans World Airlines, Inc., In re, 18 F.3d 208 (3d Cir. 1994)	9
Turner v. *Small Bus. Admin.*, 84 F.3d 1294 (10th Cir. 1996)	10
United States v. *Norton*, 717 F.2d 767 (3d Cir. 1983)	4-5, 7
Yale Express Sys., Inc., In re, 362 F.2d 111 (2d Cir. 1966)	2
Statutes:	
Bankruptcy Code, 11 U.S.C. 101 *et seq.*	1
Ch. 3, 11 U.S.C. 301 *et seq.*:	
11 U.S.C. 362(a)(3)	3

Statutes—Continued:

	Page
Ch. 5, 11 U.S.C. 501 *et seq.*:	
11 U.S.C. 506	1, 2
11 U.S.C. 524	6
11 U.S.C. 553	1, 2, 3, 4, 6, 7, 9
11 U.S.C. 553(a)	2, 6
Ch. 7, 11 U.S.C. 701 *et seq.*	6
Ch. 11, 11 U.S.C. 1101 *et seq.*	6
11 U.S.C. 1141	3, 4, 6
11 U.S.C. 1141(b)	3
11 U.S.C. 1141(c)	1, 2, 4

Miscellaneous:

Collier on Bankruptcy (15th rev. ed. 1998):	
Vol. 4	2
Vol. 5	4, 7

In the Supreme Court of the United States

OCTOBER TERM, 1997

No. 98-130

UNITED STATES OF AMERICA, PETITIONER

v.

CONTINENTAL AIRLINES
THOMAS E. ROSS, TRUSTEE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

1. a. To justify the minority view that a creditor's setoff rights become extinguished with the confirmation of a plan of reorganization, respondent has devised a novel reading of the Bankruptcy Code. Respondent maintains that a "conflict" exists between Sections 506 and 553 of the Bankruptcy Code (11 U.S.C. 101 *et seq.*) and that this conflict may be "reconciled" by an inference that Congress intended to treat setoff rights the same as secured claims that may be discharged upon confirmation of a plan under Section 1141(c) of the Bankruptcy Code. Br. in Opp. 15-17. None of the cases cited by respondent (*ibid.*) interprets the Code that way and its theory does not comport with the Code's text.

On its face, Section 506 simply determines how much of a creditor's claim involving a setoff right should be afforded status as a "secured" claim: an allowed claim subject to setoff is "a secured claim * * * to the extent of the amount subject to setoff, * * * and is an unsecured claim to the extent that the value of * * * the amount so subject to setoff is less than the amount of such allowed claim." 11 U.S.C. 506. From that language, respondent asserts that a setoff should be treated like any other secured claim, which

may be discharged under Section 1141(c). Br. in Opp. 17. That novel construction, however, is flawed. A setoff enjoys the benefits of a secured claim under the Code, but it is more than that. Judge Friendly has described a right of setoff as "security of the most perfect kind," *In re Yale Express System, Inc.*, 362 F.2d 111, 114 (2d Cir. 1966), and "the finest kind of security," *In re Lehigh & Hudson River Ry.*, 468 F.2d 430, 434 (2d Cir. 1972). Whereas other forms of secured claims, such as liens or mortgages, may be discharged, a setoff right is unaffected by a discharge of debts through liquidation or confirmation of a reorganization plan. Those other forms of secured claims are not subject to any provision comparable to Section 553, which states that "[e]xcept as otherwise provided in this section and in sections 362 and 363 of this title, this title *does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor*." 11 U.S.C. 553(a) (emphasis added). Nothing in Section 506 suggests an intent by Congress to negate the plain language of Section 553.[1] Indeed, nowhere in its opinion does the court below even cite, much less discuss, Section 506. See Pet. App. 1a-17a.

---

[1] As 4 *Collier on Bankruptcy* ¶ 506.03[1][b] (15th rev. ed. 1998) explains:

> Conceivably, Congress might have abrogated setoff rights in all bankruptcy proceedings. In practice, Congress has not done so, and two principal policies explain Congress' favorable treatment of setoff rights under the Code. First, a right of setoff is a remedy that has long been recognized and enforced in the commercial world at large, as well as under every one of the nation's bankruptcy acts, in part as a matter of essential fairness, but more importantly in recognition of the right as part of the bundle of substantive rights that may comprise a creditor's claim. Second, recognizing and preserving rights of setoff is thought to lessen the likelihood of a debtor's filing for bankruptcy relief in the first place, thus promoting the policy of bankruptcy avoidance.

b. Ultimately, even respondent's alternative theory turns on the interrelationship between Sections 553 and 1141, because Section 1141 concerns the discharge of secured claims. Yet having adopted for purposes of the brief in opposition a theory of setoff rights not passed upon by any court, respondent essentially abandons the reasoning of the court of appeals in this case. As we explain in the petition (Pet. 10-11), the court below grounded its decision on the erroneous view that property held by the creditor that is subject to a setoff right is nonetheless "property of the estate" under Section 1141. In *Citizens Bank of Maryland* v. *Strumpf*, 516 U.S. 16, 21 (1995), this Court decided as a matter of law that funds held by a creditor subject to a setoff claim are not "property of the estate" for purposes of the automatic stay provision, Section 362(a)(3). As the Court emphasized, a chose in action is not the kind of "property" that nullifies a creditor's setoff right under Section 553: the creditor's "temporary refusal to pay was neither a taking of possession of [the debtor's] property nor an exercising of control over it, but merely a refusal to perform its promise," which "§ 542(b)'s 'except[ion]' and § 553's general rule were plainly intended to permit." 516 U.S. at 21.

The Court's explanation for that holding is equally applicable in construing "property of the estate" under Section 1141. The reason a secured creditor loses its collateral if not preserved in a confirmed plan is because the debtor's estate owns the property in question. Section 1141(b) applies to cut off the secured creditor's unreserved rights. In the case of setoff, as *Strumpf* makes clear, the debtor's estate owns only a chose in action to recover the funds, not the funds themselves. If a temporary refusal to pay funds that are subject to a setoff claim does not encompass "property of the estate" for purposes of the automatic stay provision, there is no reason why it should be "property of the estate" subject to discharge under Section 1141. The court of appeals' rationale, therefore, is inconsistent with *Strumpf*.

In amending its opinion, the court of appeals acknowledged as a matter of fact that the funds subject to the setoff right were still held by the government when the plan of reorganization was confirmed (Pet. App. 16a); those funds thus were not "property of the estate" within the ordinary meaning of Section 1141(c). Yet the court opined that, "[e]ven though the actual funds themselves may not have passed as property of the bankruptcy estate, upon confirmation of the plan, [respondent] did acquire a claim or interest in them subject only to final resolution of the Government's appeal." Pet. App. 16a-17a. As we explain in the petition (Pet. 11-12), that conclusion turns settled expectations of setoff rights upside down. It takes property over which two entities have competing claims and awards it to the debtor without first adjudicating who rightfully owns it. A debtor's mere claim to ownership of funds held by a creditor when the plan is confirmed cannot, under the reasoning of *Strumpf*, be "property of the estate" subject to discharge under Section 1141(c) over a creditor's competing setoff claim.

2. As we explain in our petition (Pet. 12-14), this case would have come out differently in the Ninth and Tenth Circuits, see *In re De Laurentiis Entertainment Group, Inc.*, 963 F.2d 1269 (9th Cir.), cert. denied, 506 U.S. 918 (1992); *In re Davidovich*, 901 F.2d 1533 (10th Cir. 1990) (per curiam), and in the "majority of the courts that have addressed the issue [which] answer that confirmation and discharge do not prohibit the defensive use of setoff in a subsequent action by the debtor. A minority, however, take the opposite view." 5 *Collier on Bankruptcy* ¶ 553.08[1] (15th rev. ed. 1998).

Respondent errs in contending (Br. in Opp. 4) that *In re De Laurentiis* is distinguishable. In that case the Ninth Circuit framed the issue as "which of the two code sections controls"—Section 553 or Section 1141. 963 F.2d at 1275. In adopting the "majority view['s] strong support for the primacy of section 553" (*id.* at 1276), the court expressly rejected (*id.* at 1275) the Third Circuit's decision in *United*

States v. *Norton*, 717 F.2d 767 (1983), and cited as supporting authority (963 F.2d at 1276) the Tenth Circuit's decision in *In re Davidovich*, *supra*. The Ninth Circuit further noted that several bankruptcy courts "have reached the opposite conclusion, however." 963 F.2d at 1276. As the Ninth Circuit summarized its holding:

> We conclude that section 553 must take precedence over section 1141. In reaching this conclusion, we rely not only on the foregoing persuasive authority, but also on the language and structure of section 553 and the policies which underlie it. Section 553 provides that, with listed exceptions not relevant here, "this title does not affect the right of any creditor to offset a mutual debt. . . ." This language not only establishes a right to setoffs in bankruptcy, subject to enumerated exceptions, but seems intended to control notwithstanding any other provision of the Bankruptcy Code. To give section 1141 precedence would be to ignore this language.

Id. at 1276-1277. Only *after* basing its holding on prevailing judicial precedents and a construction of the Bankruptcy Code did the court cite factual matters that illustrated the "unfairness" of a contrary result. See *id.* at 1277. Thus, the facts upon which respondent tries to "distinguish[]" (see Br. in Opp. 4) the court's decision were not the basis for the Ninth Circuit's ruling.[2]

---

[2] In any event, the unfairness of extinguishing the United States' setoff rights here is fully comparable to that found by the court in *In re De Laurentiis* for the creditor there. The United States took steps analogous to those taken by the creditor in *In re De Laurentiis* to preserve its setoff rights. First, respondent points out that in *In re De Laurentiis*, the creditor "timely filed a proof of claim asserting setoff" (Br. in Opp. 4). Similarly here, the United States filed timely proofs of claim and through the proof of claim filed by the Federal Aviation Administration served notice to the debtor and the estate that "[t]he United States reserves its

Similarly unpersuasive is respondent's denial of a conflict with the Tenth Circuit's conclusion in *In re Davidovich*. As our petition notes (Pet. 14), Section 553 controls in Chapter 7 and Chapter 11 bankruptcies alike. The court in *In re Davidovich* made it a point to "reaffirm our holding in [*In re G.S. Omni Corp.*, 835 F.2d 1317 (10th Cir. 1987)] that filing of a proof of claim is not a prerequisite to assertion of a right to setoff under 11 U.S.C. § 553 and hold further that a discharged debt may be setoff upon compliance with the terms and conditions stated in section 553 of the Code." 901 F.2d at 1539. The judgment below cannot be squared with that holding. Whether the order discharging the debtor's debts in bankruptcy is issued under Section 524 (as in *In re Davidovich*) or Section 1141 (as here), Section 553 could not be clearer that "*this title* [Title 11 of the United States Code] *does not affect* any right of a creditor to offset" a mutual debt owed by that creditor to the debtor. 11 U.S.C. 553(a) (emphasis added). Our position is, and the Ninth and Tenth Circuits agree, that the Section 553 setoff right is unaffected by

---

right to effect any and all appropriate setoffs." See Pet. 2-3; C.A. App. 40. Such a statement, which was filed without any objection by the debtor, estate, or any creditor, is sufficient "to preserve that right, even under the most stringent standard." See *In re Chateaugay Corp.*, 94 F.3d 772, 777 (2d Cir. 1996). Second, as in *In re De Laurentiis*, there is no question of unfair surprise. Respondent does not contest the fact that many months prior to confirmation the debtor and estate were fully aware that the United States was attempting to preserve and assert its setoff rights against any moneys owed to Continental from the *Alaska Airlines* litigation (*Alaska Airlines, Inc.* v. *Austin*, 801 F. Supp. 760 (D.D.C. 1992), aff'd in part, rev'd in part, 8 F.3d 791 (Fed. Cir. 1993)), before turning those funds over to the estate. See Pet. 4-5 (describing proceedings in the Federal Circuit to preserve the government's setoff rights before plan confirmation). Thus, as in *In re De Laurentiis*, petitioner "pursued its claim diligently before the bankruptcy court at all times" (Br. in Opp. 4 (quoting 963 F.2d at 1271)). See Pet. 5-6 (describing government appeals of orders denying preservation of setoff rights in the district court and court of appeals).

the discharge of debts in bankruptcy, whether through a liquidation or reorganization proceeding. Courts and commentators alike cite and discuss the divergent Third, Ninth, and Tenth Circuit cases to glean the meaning of Section 553 and its relationship to other provisions of the Bankruptcy Code. See Pet. App. 9a-13a; *In re De Laurentiis*, 963 F.2d at 1275-1276; 5 *Collier on Bankruptcy* ¶ 553.08[1].[3] And the Second Circuit has noted a conflict among the courts on whether a "failure to assert a setoff right specifically in a proof of claim is a waiver of that right." *In re Chateaugay Corp.*, 94 F.3d 772, 777 (1996).

3. Respondent devotes much of its brief in opposition to arguing alternative grounds on which an affirmance of the decision below might be based. Br. in Opp. 7-15. Because those assertions involve issues not passed on or decided by the court of appeals, they do not justify a denial of certiorari in light of the conflict in the circuits on the important question the court of appeals did decide. As to each of the alternative grounds, on remand respondent can renew its argument if the Court agrees with petitioner and reverses the court of appeals' judgment.

First, respondent asserts that petitioner "[c]annot [s]et [o]ff [a]gainst [f]unds [w]hich Continental [o]wns." Br. in Opp. 7. That contention addresses the merits of petitioner's underlying claim to setoff, which neither the court of appeals nor the district court addressed because both courts ruled as

---

[3] Respondent further suggests that, because "the Third Circuit below merely follows its prior opinion in *Norton*, the situation has not changed since this Court denied certiorari in *De Laurentiis*." Br. in Opp. 5-6. *Strumpf* was decided after *In re De Laurentiis*, however, and it makes clear that the rationale underlying *Norton* is no longer sound. Moreover, because the court below extended *Norton* to extinguish a creditor's setoff rights *after* confirmation of a reorganization plan or discharge of claims, its decision is all the more indistinguishable from *In re DeLaurentiis* or *In re Davidovich*, which upheld the opposite rule. Nor is it consistent with this Court's decision in *Strumpf*.

a matter of law that petitioner's "set-off rights, *if any*, were extinguished upon confirmation of [respondent's] Plan of Reorganization." Pet. App. 14a (emphasis added); *id.* at 30a (emphasis added).

Next, respondent contends that the plan of reorganization "[s]pecifically [p]rohibits [s]etoff without Continental's [c]onsent." Br. in Opp. 8. That contention, on which the court of appeals did not rely (compare Pet. App. 12a-13a with Resp. C.A. Br. 25-26), misreads the plan of reorganization. See Br. in Opp. App. 20a. Paragraph 14.8 of the plan, which respondent quotes (Br. in Opp. 8), speaks only of the reorganized debtor's right to set off payments under the reorganization plan against debts owed to it. That paragraph does not address the setoff rights of creditors. It does not address the funds being sought by respondent in the *Alaska Airlines* litigation (see Pet. 3-4) or purport to distribute those funds to the creditors. Respondent's argument is that because the plan of reorganization specifically refers to the *debtor's* setoff rights against third parties, it should also be read implicitly to encompass the setoff rights of *creditors* against the debtor.[4] Even if that argument had legal support (and respondent cites none), respondent is free to re-argue it on remand after a reversal of the court of appeals' decision.

Third, respondent maintains that petitioner "[w]aived [i]ts [r]ight of [s]etoff," while acknowledging that "[t]he District Court and the Third Circuit did not find it necessary to reach this point." Br. in Opp. 11. That contention too can be ad-

---

[4] Respondent also contends that the district court made findings of fact that foreclose petitioner's contention. See Br. in Opp. 10-11 (discussing Pet. App. 29a-30a). Those findings, however, were based on the court's reading of the plan, and petitioner contested that construction in the court of appeals. See Gov't C.A. Br. 26-30; Gov't C.A. Reply 13-14. By deciding the case only on the ground that confirmation of the plan extinguished petitioner's setoff rights, the court of appeals left open any arguments that might be made on remand about how the plan language should be interpreted. See Pet. App. 13a-14a.

dressed on remand. In any event, in arguing that "[t]he right to setoff is waived if not asserted when the creditor elects to participate in the bankruptcy case by filing a claim" (*ibid.*), respondent is merely restating the question on which the courts are divided and which we have presented for this Court's review. See, *e.g.*, *In re Davidovich*, 901 F.2d at 1539 ("filing of a proof of claim is not a prerequisite to assertion of a right to setoff under 11 U.S.C. § 553"). As a factual matter, there was neither any waiver of setoff rights by petitioner nor any unfairness to respondent in the way petitioner sought to preserve those rights. When ordered by the district court in *Alaska Airlines* to pay the estate the funds (before asserting a setoff right), petitioner filed an immediate appeal and (on December 23, 1992) obtained both an emergency stay as to the airlines in the bankruptcy proceedings and, thereafter, a modification of the district court's order from the Court of Appeals for the Federal Circuit. C.A. App. 26-27; *In re Trans World Airlines, Inc.*, 18 F.3d 208, 214-215 (3d Cir. 1994). Four days after the Federal Circuit's order, on April 16, 1993, the reorganization plan was confirmed. Thus, when the plan was confirmed, the debtor was well aware that petitioner had preserved its setoff rights and had no intention of waiving those rights.

Finally, respondent contends that the "[o]bligations [h]ere [l]ack the [m]utuality [r]equired for [s]etoff." Br. in Opp. 13. Respondent's premise is that each federal agency should be treated as a separate creditor. See *id.* at 13-14. The great weight of authority is to the contrary. As this Court held in analogous circumstances in *Cherry Cotton Mills, Inc.* v. *United States*, 327 U.S. 536, 539 (1946), "[w]e have no doubt but that the set-off and counterclaim jurisdiction of the Court of Claims was intended to permit the Government to have adjudicated in one suit all controversies between it and those granted permission to sue it, whether the Government's interest had been entrusted to its agencies of one kind or another." Although *Cherry Cotton Mills* was

decided prior to enactment of the Bankruptcy Code, post-Code court of appeals decisions have applied its reasoning to bankruptcy cases involving multiple federal agencies. See, *e.g.*, *In re HAL, Inc.*, 122 F.3d 851, 853 (9th Cir. 1997); *Turner* v. *Small Bus. Admin.*, 84 F.3d 1294, 1297-1298 (10th Cir. 1996) (en banc).

4. Respondent does not contest the importance of the question presented for the administration of the bankruptcy laws. See Pet. 14-19. Indeed, respondent's rule (Br. in Opp. 17)—that petitioner "needed to object just like any other holder of a secured claim"—invites the very problems we identify in the petition. It is impracticable for the government to monitor every reorganization plan filed in the bankruptcy courts of the Nation and to file an objection to its entry on the chance that a debtor may attempt to assert a claim for monetary payment from a government agency that may be subject to a setoff. It is also contrary to sound practice to promote a rule that will protract bankruptcy proceedings by requiring the holders of setoff rights—both governmental and non-governmental—to monitor, litigate, and object to plans that do not adequately protect those rights. And it is contrary to fundamental principles of bankruptcy law to permit a debtor such as respondent to shield assets from its estate while denying to creditors the opportunity to offset mutual pre-petition debts. Congress sought to prevent such results and to retain the centuries-old protection of creditors' setoff rights when it enacted Section 553.

* * * * *

For the reasons stated above and in the petition for a writ of certiorari, the petition should be granted.

Respectfully submitted.

SETH P. WAXMAN
Solicitor General

SEPTEMBER 1998